

CLIENT ALERT

California Supreme Court Increases the Cost of M&A Deals in Expansive Real Estate Transfer Tax Decision

July 26, 2017

On June 29, 2017, the Supreme Court of California issued a decision that may create a trap for the unwary for persons acquiring or selling businesses. In *926 North Ardmore Avenue, LLC v. County of Los Angeles*, the Court held that California's documentary transfer tax applies to conveyances of interests in legal entities that own real estate if the conveyance results in a transfer of beneficial ownership in real estate, which is determined based on the "change of ownership" provisions of California's property tax law. The decision could have widespread impact.

By authorizing counties and cities to tax transfers of interests in legal entities even where no property is sold directly, the Court effectively converted the documentary transfer tax into a controlling interest transfer tax. This judicial broadening of the California real estate transfer tax potentially increases the costs associated with acquisitions of entities that own California real estate regardless of whether the real estate is at the heart of the transaction.

Background

In the early 1980s, New York State and City imposed a real estate transfer tax on the transfer of real property by deed. However, after Pan American World Airways avoided a \$4 million tax bill on the transfer of its 59-story Pan Am Building in Manhattan to the Metropolitan Life Insurance Company by transferring stock instead of a deed, New York City Mayor Ed Koch insisted that the State legislature close the alleged loophole. Shortly thereafter, the Legislature amended the law. The so-called "Pan Am tax" applied to transfers of controlling economic interests in legal entities that own real estate as well as to transfers of real property by deed. However, New York's Pan Am tax closed the supposed loophole prospectively only, and Pan American World Airways was never asked to pay tax on the completed transfer.

Most states have some form of excise tax applicable to transfers of real estate. And over the past 35 years, numerous states have adopted controlling interest transfer taxes either by enacting new legislation or amending existing real estate transfer tax laws. These controlling interest transfer taxes vary from state to state.¹ Until now, none was created by judicial interpretation.

The Opinion

By a 6-1 margin, the Supreme Court of California held that Los Angeles County properly applied the documentary transfer tax to the transfer of interests in a partnership that indirectly owned real estate through a single member limited liability company even though the property was not sold directly and no document evidencing a transfer was recorded. It has been reported that some California cities and counties had been applying the tax to transfers in property-owning legal entities for some time, but the majority of California jurisdictions previously applied the tax only to direct transfers of real property by deed.

The *926 North Ardmore* case involved the indirect transfer of a building in Los Angeles initially owned by a couple. In 1972, the couple transferred the building to a family trust. After the husband passed away, the trust's assets including the building were transferred to an administrative trust maintained for the wife's benefit, with the wife's sons named as trustees.

Many years later, in 2008, the trustees formed a single member LLC to which the trust transferred the building, and a limited liability limited partnership in which the trust owned 99 percent. The trust transferred its LLC interest to the LLLP and then distributed its 99 percent ownership interest in the LLLP to four subtrusts also maintained for the wife's benefit. Although legal title to the building moved between these various family trusts prior to the transfer at issue in the case, the wife retained an indirect beneficial interest in the building throughout.

Then, in 2009, three of the four subtrusts transferred their interest in the LLLP to two separate trusts maintained for the benefit of the wife's two sons. Consequently, each of the sons acquired an indirect 44.595 percent beneficial interest in the building.

Following the 2009 transfer, the sons filed the requisite "change of ownership" notice with Los Angeles County in compliance with California *property tax* law. A change of ownership triggers reappraisal and reassessment for property tax purposes.²² However, the sons did not report or pay any *real estate transfer tax* because no deed transferring real property was recorded. In 2011, Los Angeles County issued an assessment for documentary transfer tax on the transfer of the interests in the LLLP to the sons, and the taxpayer appealed.

Section³³ 11911 permits counties to levy a tax "on each deed, instrument, or writing by which any lands, tenements, or other realty sold within the county shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers," if "the consideration or value of the interest or property conveyed" exceeds \$100. Despite the prior consistent understanding of tax practitioners that the tax was limited to documents that directly reference and transfer real property, the Supreme Court held that the documentary transfer tax may be imposed whenever a transfer of a legal entity results in a change in ownership of real property under subdivision (c) or (d) of section 64.

Under section 64(c), when any person obtains more than 50 percent control or ownership in a corporation or other legal entity in a purchase or transfer of stock or ownership interest, the purchase or transfer is deemed a change of ownership in the real property owned by the corporation or other legal entity in which the controlling interest is obtained.⁴⁴

Under section 64(d), if a transfer of real property to a legal entity is deemed not to be a change of ownership because it results in a change in the method of holding title but not in the proportional interests of the owners in the real property, then a subsequent transfer of ownership interests representing cumulatively more than 50 percent of the total interests in the entity by the original co-owners is deemed a change of ownership in the real property owned by that legal entity.

The Court was not interpreting these statutory "change of ownership" provisions, which are in the property tax chapter of the Revenue and Taxation Code. Instead, the court for the first time has incorporated these provisions into the transfer tax chapter of the Code to determine when the transfer tax is triggered. Nothing in California's transfer tax statutes references the property tax statutes or "change of ownership." The Court appears to have adopted its interpretation by judicial fiat.

Observation

The Court may have been influenced by the facts of this case, which were particularly egregious. The use of a family trust and the several transfers of interests appeared to have been structured to avoid tax. Thus, in rejecting the taxpayer's argument that the tax only applies to deeds transferring real property, the Court suggested that such an approach would elevate form over substance.⁵⁵ In fact, one might have anticipated – or even expected – a narrow decision incorporating into the transfer tax law the type of ownership changes described in section 64(d). However, the Court's adoption of the change of ownership definition in section 64(c) as well as section 64(d) makes clear that this decision is not just a means to attack abusive tax transactions but will apply much more broadly to any transfer to any person of a controlling interest in a legal entity that owns real property.

Furthermore, because the Court has interpreted the meaning of the law as it has always existed, this decision does not have an effective date as a legislative change would have. One would hope that local taxing jurisdictions will apply California's controlling interest transfer tax prospectively only, but a tax assessor might look further back to transactions that have long since been completed. Absent legislative intervention, each California jurisdiction with responsibility for this kind of transfer tax will decide how to implement the Supreme Court's *926 North Ardmore* decision.

Looking Ahead

We expect that California cities and counties will welcome the Court's invitation to tax transfers of interests in legal entities that own real estate and will begin monitoring business deals more closely. The Court's decision also may embolden jurisdictions in other states with similar statutes to extend their transfer taxes – including sales & use taxes – to transfers of interests in legal entities.

If you are negotiating or have recently closed a deal and need help navigating the complex area of controlling interest transfer taxes, please call one of the authors of this alert.

¹ For example, some controlling interest transfer taxes apply to transfers of any legal entity that owns real estate while others are limited to REITs and similar "real estate" companies.

² After receiving the change of ownership notice, the Los Angeles County assessor issued a supplemental property tax assessment to the LLC which the LLC did not dispute.

³ All "section" references are to the California Revenue and Taxation Code.

⁴ The Court of Appeal in *926 North Ardmore* held that section 64(c) did not apply to this case because each son acquired less than 50 percent.

⁵ State courts do not limit application of federal judicial common law doctrines to income tax cases. *See, e.g., Sullivan Bros. v. Wis. Dep't of Revenue*, 843 N.W.2d 711 (Wis. Ct. App. 2014) (applying the economic substance doctrine to uphold a use tax assessment on transactions involving related entities).

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