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California's Proposition 13, passed in 1978 and contentious then, was intended to protect taxpayers from dramatic rises in their annual property tax bills. In this article, Alston & Bird's Charles Wakefield and Clark Calhoun discuss reasons why Prop 13 remains controversial to this day.

What Makes a Loophole? Prop 13 and Change of Ownership

BY CHARLES WAKEFIELD AND CLARK CALHOUN

Introduction

Few laws, if any, have had a bigger impact on a state's taxing authority than California's Proposition 13 (Prop 13). Famously passed in 1978 amidst a housing market boom, Prop 13 was intended to protect taxpayers from dramatic rises in their annual property tax bills by limiting the ad valorem taxes on real property to 1 percent of the full cash value of the property at acquisition, with a 2 percent annual cap on assessment increases. From its genesis, proponents argued that Prop 13 would harness wasteful spending and promote economic growth by keeping taxes low. Critics said it would deprive local governments of essential funding for schools and public services. Throwing caution to the wind, Californians overwhelmingly approved the measure by a nearly two-thirds vote. Yet, despite the fact that Prop 13 is nearly 40 years old, it is just as controversial today as it was at its inception.

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Perhaps the most friction-laden aspect of Prop 13 is the ''change in ownership'' requirement. Prop 13 permits local assessors to reassess tax based on current fair market value only when a change of ownership occurs. Because of the strict limitations on annual ad valorem tax increases, this reassessment trigger has become a focal point for controversy, as it presents assessors with their primary opportunity to reset a property's value to its current fair market value. Unfortunately, Prop 13 did not itself define what it means to have a ''change in ownership,'' and thus left it to the Legislature to determine the phrase's meaning. The result was section 64 of the California Revenue and Taxation Code. Under section 64, a change of ownership occurs when an entity or individual acquires (i) the property itself or (ii) more than 50 percent of the ownership inter-

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est in an entity that owns the property. Although seemingly benign, some California lawmakers say the codified definition of ''change of ownership'' spawned a tax planning ''loophole'' that commercial property owners may use to avoid reassessment when properties change hands.

The Perceived Loophole

While Prop 13 established change of ownership as the trigger for reassessment, it did not elaborate on what circumstances would result in such a change. After considerable debate, the Legislature defined a change of ownership as occurring upon the transfer of real property and specified that, in general, the transfer of an interest in an entity that owns real property is *not* a change of ownership of the underlying property. However, section 64(c) of the code sets forth a crucial exception to that general rule, requiring reassessment when any person or entity obtains control through direct or indirect ownership of ''more than 50%'' of corporation voting stock, or obtains ''more than 50%'' ownership interest in any other type of legal entity that owns the real property at issue.

The statutory requirement that more than 50 percent ownership must be transferred before property can be reassessed at current fair market value is at the heart of Prop 13's perceived loophole, because the language allowed creative taxpayers to structure transactions to avoid reassessment by acquiring no more than 50 percent by any single entity or individual. This tax planning technique has been a dull stick in the state's craw since the codification of the change in ownership rules. Over the years, certain members of the Legislature have tried, unsuccessfully, to close the perceived loophole by proposing various forms of legislation. However, as the result of one recent high-profile case, it appears the Legislature is proposing legislative ''fixes'' with renewed vigor.

The 'Dell Tax Maneuver'

The application of the ''more than 50 percent'' test for entity transfers was most recently put to the test by Los Angeles County in *Ocean Avenue LLC v. County of Los Angeles*.[1] The county assessor attempted to issue a fair market value reassessment to billionaire Michael Dell following his purchase of Ocean Avenue LLC (the owner of the Santa Monica Fairmont Hotel) in 2006. In that transaction, Dell, his wife, and two of his investment entities purchased the ownership interests in Ocean Avenue LLC, each with no more than 49 percent control of the entity. Dell contended that pursuant to sections 60 and 64 of the California R&T Code and 18 Cal. Code Regs. 462.180, because no individual or entity had gained control of *more than 50 percent* of the entity, there was no change of ownership in the property that the entity owned. Conversely, the assessor contended that it was ''too good to be true'' that such a structure could avoid reassessment under Prop 13. The California Court of Appeal held—based on the plain language of section 64 of the California Revenue and Tax Code—that there had been no change of ownership in the transaction, and it ordered the county to pay Dell's legal fees for asserting a too good to be true defense that was directly contradicted by plain statutory language.

It does not appear that public sympathies have been on the side of business taxpayers in the aftermath of the *Ocean Avenue* decision. News outlets and lawmakers have seized upon the *Ocean Avenue* decision as an emblem of a system that is slanted against individual homeowners in favor of business entities (notwithstanding the fact that, as described above, the decision simply upheld a straightforward reading of the statute's plain language).

> Suddenly, though, the Dell Tax Maneuver has crystallized a problem that many liberal activists have been complaining about for years: the property tax burden has unfairly shifted onto the shoulders of residential property owners. Owners of commercial property, they say, no longer pay their fair share because they've been able to do the Dell, avoiding reassessments when properties change hands.
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> Lenny Goldberg, a longtime Prop 13 foe who runs the California Tax Reform Association, had one word for the timing of the Dell story: ''Fabulous.''[2]

Surfing on a tide of public support following *Ocean Avenue*, the Legislature has proposed several changes that would affect business entities' ability to avoid a change of ownership upon a transfer of interests in an entity that owns California real property.

S.B. 259: Re-Defining Change of Ownership for Entity Transfers

The most recent item of legislation purporting to redefine the change of ownership rules that were highlighted by *Ocean Avenue* was S.B. 259.[3] Under S.B. 259, a change of ownership would occur if 90 percent or more of a legal entity's ownership interests are sold or transferred in a ''single transaction,'' even if no one person or entity acquires more than 50 percent of the entity's ownership interest. S.B. 259 defines a single transaction as ''a plan consisting of one or more sales or transfers of ownership interests that occur on or after January 1, 2016.'' For this purpose, the bill created a rebuttable presumption that a sale or transfer is part of a single transaction if either (1) the transferees are persons described in Internal Revenue Code section 267(b), or (2) the sales or transfers occur within a 36-month period, commencing on the date of the first sale or transfer of the ownership interests that occurs on or after Jan. 1, 2016.

Internal Revenue Code section 267(b) lists various relationships, including, but not limited to, members of a family; an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; two corporations which are members of the same controlled group; a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

[1] 227 Cal.App.4th 334 (2014).

[2] Robin Abcarian, ''*Dell Tax Maneuver could galvanize efforts to tweak Prop. 13*,'' Los Angeles Times, May 9, 2013.

[3] S.B. 259, 2014-2015 Reg. Sess. (Cal. 2015).

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and a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership. Notably, the rebuttable presumption that a sale or transfer is part of a single transaction would have been triggered for Dell's transaction if S.B. 259 were in effect at the time. Yet, despite any public sentiment that may have motivated the Legislature to propose S.B. 259, the bill to close the change-in-ownership ''loophole'' failed to pass *again*—a fact that suggests that the 40-year-old loophole is not a loophole at all, but rather is consistent with the spirit and intent of Prop 13.

When a Loophole Is Not a Loophole

A loophole is generally understood to mean an ambiguity, omission or exception that provides a way to avoid the application of a rule without violating its literal requirements.[4] One could certainly argue that the language of Prop 13 itself is ambiguous because it failed to define the phrase change of ownership. But critics of Prop 13 rarely take issue with the initiative's language. Rather, they point to the statutory and regulatory framework as flawed because a narrow set of transactions, if organized in a particular way, escape taxation. However, the legislative history of Prop 13 reveals that the codified change of ownership rules reflect a deliberate attempt by the Legislature to balance the administrative burdens of more broadly defining change in ownership with the friction between local governments and their citizenry from which Prop 13 was born. Making it harder for local governments to tax real property is Prop 13's raison d'être, and so it follows that any exceptions to the reassessment trigger are entirely consistent with the intent and spirit of Prop 13, and thus are not ''loopholes'' in the traditional sense. After all, Prop 13 wasn't just any old tax law; it was a symbol—*the* symbol—of taxpayer ''revolt.''[5]

After Prop 13's passage, the Legislature had ample opportunity to define the change of ownership provisions broadly, thereby removing any doubt that transactions like the one at issue in *Ocean Avenue* would trigger reassessment. However, the legislative history demonstrates concerns over the administrability and appropriateness of a broad definition. To determine what Prop 13's rules should be and how those rules should be implemented, the Assembly Revenue and Taxation Committee appointed a 35-member task force of state, local, and private sector professionals to evaluate the various options for defining a change of ownership and to recommend the statutory implementation for Prop 13 more generally. The task force reported its finding in the Report of the Task Force on Property Tax Administration,[6] with additional background information in Implementation of Proposition 13, Volume 1, Property Tax Assessment.[7] These publications show that no single issue was more thoroughly considered, or thought more important by the task force, than how to define a change of ownership.

From the beginning, the task force grappled with the issue of how to apply Prop 13's change in ownership provisions to property owned by a legal entity rather than an individual. The task force identified two alternative approaches: (a) the ''separate entity theory'' and (b) the ''ultimate control theory.'' Under the separate entity theory, business entities are treated as separate and distinct from their owners. Accordingly, under the separate entity theory, property may not be reassessed as long as it is owned by the same legal entity, even if the ownership interests in the legal entity are transferred. Under the ultimate control theory, on the other hand, the business entity is disregarded for purposes of determining whether a change of control has occurred (meaning that the ultimate control theory looks through the business entity to its underlying owners and would declare a change of ownership upon a transfer of ownership interests). Under the ultimate control theory, reassessment is triggered only when a majority of the ownership interest in the business entity that owns the real property is transferred.

The task force initially concluded that the separate entity theory should be adopted, and it set forth two primary reasons why:

> **[1]** The administrative and enforcement problems of the ultimate control approach are monumental. How is the assessor to learn when ultimate control of a corporation or partnership has changed? Moreover, when the rules are spelled out (and the Task Force actually drafted ultimate control statutes) it became apparent that, without trying to cheat, many taxpayers, as well as assessors, would simply not know that a change in ownership occurred. **[2]** The separate entity approach is vastly simpler for taxpayers and assessors to understand, apply, and enforce. Transfers between individuals and entities, or among entities, will generally be recorded. Even if unrecorded the real property will have to be transferred (by unrecorded deed or contract of sale, for example). Taxpayers can justifiably be expected to understand that a transfer of real property is a change in ownership and must be reported to the assessor.

While the Legislature initially followed the task force's recommendation and adopted just the separate entity theory, shortly thereafter, it changed course and enacted the ultimate control theory (now codified in section 64(c)), despite the task force's warnings regarding its inherent weaknesses. Understanding that the Legislature's general tendency would be to ''take the approach of including everything in 'change in ownership,' '' the task force expressed that it was important that ''change of ownership'' be defined in a manner ''sufficiently consistent with the normal understanding'' of that phrase.[8] It thereby undertook to ''distill'' in both its contemplated approaches a ''test which could be applied evenhandedly to distinguish between 'changes' and 'non-changes,' *both those which the task force could and those which it did not foresee*'' and ''the basic characteristics of a change in ownership.''[9] Thus, although the task force did not recommend the ultimate control approach, it clearly believed that any metric other than majority control would stretch change in ownership beyond what was intended by Prop 13's vot-

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[4] Blacks's Law Dictionary (10th ed. 2015).
[5] *See* e.g., Richard Boeth et al., *The Big Tax Revolt*, Newsweek, June 19, 1978.
[6] Cal. St. Assembly Pub. 723 (Jan. 22, 1979).
[7] Cal. St. Assembly Pub. 748 (Oct. 29, 1979).

[8] Cal. St. Assembly Pub. 723 at 38.
[9] Cal. St. Assembly Pub. 723 at 38 (emphasis added).

ers. If that meant that some transactions involving entities that own California real property did not constitute a change of ownership, so be it: after all, imposing strict limits on assessors' ability to reassess properties was the whole point of Prop 13, and to define any transaction that would not traditionally be understood to constitute a change of ownership would have violated the spirit of that important new constitutional provision.

Whether or not the ability to structure transactions around the application of section 64(c) is classified as a loophole, the Legislature was certainly on notice from the beginning that the ultimate control method would inevitably fail to capture every type of transaction for purposes of reassessment. In fact, the task force specifically noted that Prop 13's change of ownership requirement placed the state in a ''no win'' situation, because it forced the state to adopt rules that could never deliver to local governments the same expansive powers to assess property as those they enjoyed before Prop 13 became law. So long as there is a change of ownership requirement, there will always have to be an inflection point, be it more than 50 percent to a single owner (as under the present law) or 90 percent of all interests, as under the recent S.B. 259. This may be small solace to those who believe that the status quo unfairly shifts the tax burden from large commercial property owners to individuals who only own their homes, but so long as there is a change of ownership rule, there will always be a somewhat artificial inflection point: below the threshold is *not* a change of ownership, but above the threshold is. Furthermore, the task force's thoughtful analysis in evaluating how to define the phrase demonstrates that the current definition is no accident; rather, it is an attempt to capture only those transactions that would normally be considered to constitute a change of ownership, consistent with the will of the voters who ratified Prop 13. Accordingly, it is time for the Legislature to put to rest the idea that Prop 13 needs to be ''fixed'' with respect to this issue, as the phrase was carefully defined so as to permit reassessments only when a change of ownership has unequivocally occurred.

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