



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

|                |          |                 |                                                     |
|----------------|----------|-----------------|-----------------------------------------------------|
| Date:          | 01/04/12 | Bill No:        | <a href="#">Assembly Bill 448</a>                   |
| Tax Program:   | Property | Author:         | Ammiano                                             |
| Sponsor:       | Author   | Code Sections:  | RTC 64, 480.1, 480.2, 480.9, 482, 486. 486.5, & 488 |
| Related Bills: |          | Effective Date: | Upon enactment                                      |

### BILL SUMMARY

This bill creates a new event that would trigger a “change in ownership” of property owned by a legal entity. Specifically, this bill would:

- Provide that when **100 percent** of the ownership interests in a legal entity are sold or transferred in a **single transaction**, as defined, that event **shall be considered a change of ownership** of all the real property owned by the legal entity requiring a reassessment of all the real property owned by the legal entity. §64(c)(1)(B)(i)
- Define “**single transaction**” to mean
  - a transaction in which 100 percent of the ownership interests are sold or transferred in either one calendar year, or
  - a transaction in which 100 percent of the ownership interests are sold or transferred within a three-year period beginning on the date of the original transaction when any percentage or ownership interests are sold or transferred. §64(c)(1)(B)(ii)(III)
- Require the Board of Equalization (BOE) to notify assessors when such a change in ownership has occurred. §480.9

In addition, this bill would:

- Increase the penalty for failure to fail a change in ownership statement with the BOE from 10% to 20%.
- Expressly authorize the BOE to prescribe regulations as may be necessary to carry out the purposes of Section 64(c)(1)(B). §64(f)

### ANALYSIS

#### CURRENT LAW

**Change in Ownership.** Under existing property tax law, real property is reassessed to its current fair market value whenever there is a “change in ownership.” (*California Constitution Article XIII A, Sec. 2; Revenue and Taxation Code Sections 60 - 69.5*)

**Interests in Real Property.** Revenue and Taxation Code Section 61(j) provides that change in ownership includes the transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner or any other person.

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**Interests in Legal Entities.** Revenue and Taxation Code Section 64 sets forth the change in ownership provisions related to the purchase or transfer of ownership interests in legal entities that own real property (e.g., stock in a corporation, interests in a limited liability company, or interests in a partnership). Section 64(a) provides the general rule that transfers of interests in legal entities do not constitute changes in ownership (and, therefore, no reassessments) of the real property owned by those legal entities. However, there are two exceptions to that general rule. The first exception is when there is a “change in control” of the legal entity. The second exception is when persons that are deemed “original coowners” of the legal entity cumulatively transfer more than 50 percent of their ownership interests in that legal entity. Specifically:

- **Change in Control of Legal Entity.** Section 64(c) provides that when any person or entity obtains control through direct or indirect ownership or control of **more than 50 percent** of the voting stock of a corporation, or obtains more than a 50 percent ownership interest in any other type of legal entity, a reassessment of will occur of all real property owned by the acquired legal entity (and any entity under its control) as of the date of the change in control.
- **Cumulative Transfers by “Original Coowners.”** Section 64(d) provides that when voting stock or other ownership interests representing **cumulatively more than 50 percent** of the total interests in a legal entity are transferred by any of the “original coowners”<sup>1</sup> in one or more transactions, the real property which was previously excluded from change in ownership under Section 62(a)(2), shall be reassessed.

**Self Reporting Requirement.** Existing law requires a change in ownership statement (LEOP COS) to be filed with the BOE within 90 days of the date of the event that triggers a change in control or change in ownership of a legal entity under Section 64(c) or (d). In the case of a change in control under Section 64(c), the person or legal entity that *acquired* control of the legal entity is responsible for filing the LEOP COS. If a person or legal entity does not file the required LEOP COS within 90 days, a penalty is applicable. The penalty amount is 10 percent of the taxes applicable to the new base year value reflecting the change in control or change in ownership of the real property owned by the legal entity.

**Requirement to File Upon Request.** To help discover unreported changes in control and changes in ownership of legal entities, the law requires that the BOE participate in the discovery of changes in control and ownership of legal entities under Section 64(c) and (d). To this end, the primary method is an annual inquiry of all legal entities via the state income tax return. The BOE also makes formal written requests to legal entities to investigate possible changes in ownership based on information it obtains from monitoring business publications and referrals it received from local assessors or other

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<sup>1</sup> **Proportional Ownership Interests Exclusion Creates “Original Coowner” Designation.** Under Section 62(a)(2), a transfer of real property to a legal entity does not result in a reassessment if the transfer is merely a change in the method of holding title and the proportional ownership interests in the real property are *exactly* the same before and after the transfer. However, after a transfer of real property qualifies for this exclusion from reassessment, the persons holding ownership interests in the legal entity immediately after the transfer are considered “**original coowners**” for purposes of tracking subsequent transfers by original coowners of those interests. When such transfers cumulatively exceed 50 percent, the real property previously excluded from reassessment under Section 62(a)(2), is deemed to undergo a change in ownership, and is, therefore, subject to reassessment under Section 64(d).

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sources. An entity of subject to penalty for failure to respond to the BOE. (If it is later determined that a change in control or change in ownership did occur, and was not previously self-reported to the BOE, then a penalty would have been triggered previously --because it was not reported within 90 days of the event.)

#### PROPOSED LAW

**Transfers of Ownership Interests in Legal Entities: New Change in Ownership Triggering Event.** This bill would add a new subparagraph (B) to Section 64(c)(1) to provide that in the event that **100 percent** of the ownership interests in a legal entity are sold or transferred in a **single transaction**, whether by merger, acquisition, private equity buyout, transfer of partnership shares, or any other means by which a legal entity or person acquires the ownership interests of another legal entity, including the subsidiaries or affiliates of the legal entity and the property owned by those subsidiaries or affiliates, the purchase or transfer of the ownership interests **shall be a change of ownership** of the real property owned by the legal entity, **whether or not any one** legal entity or person that is a party to the transaction **acquires more than 50 percent** of the ownership interests. Furthermore, it would define “single transaction” to also mean a transaction in which 100 percent of the ownership interests in either **one calendar year or within a three-year period** beginning on the date of the original transaction when any percentage or ownership is sold or transferred. §64(c)(1)(B)

**BOE Discovery.** This bill would add Section 480.9 to require that the BOE notify assessors when a change in ownership as described by new Section 64(c)(1)(B) occurs. §480.9

**Definitions.** For purposes of subparagraph (B) of Section 64(c)(1), this bill would define “legal entity” to mean a corporation, a partnership, a limited liability company, or other legal entity. It would define “ownership interests” to mean corporate voting stock, partnership capital and profits interests, limited liability company membership interests, and other ownership interests in legal entities. §64(c)(1)(B)(ii)(I) and (II)

**Regulations.** This bill would add subdivision (f) to authorize the BOE to prescribe regulations as may be necessary to carry out the purposes of Section 64. §64(f)

**Legislative Findings and Declarations.** This bill includes an uncodified statement of Legislative intent. It reads:

The Legislature finds and declares all of the following:

(a) The system for determining a change in ownership for the purpose of assessment of commercial property is complex and difficult to administer.

(b) Property owners use complex legal maneuvers and methods of dividing up, or obscuring, ownership patterns, in order to avoid reassessment when changes of ownership actually occur.

(c) There are many circumstances where changes of ownership have legally taken place, which are often not known to the assessor because they are deliberately obscured, such as keeping the property in the name of the old property owner even when a company is purchased.

(d) Deeds are filed that describe ownership patterns of such complexity that it is difficult for the legal powers of the counties, and the enforcement powers of the assessor, to be exercised.

(e) Transactions occur that should be identified as changes of ownership, such as a 100-percent purchase of a company, which avoid reassessment because of the ability to divide ownership shares.

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(f) Penalties for obscuring, or failing to report, transactions are insufficient to provide incentives to purchasers to self-report, making the job of identifying these transactions by the assessor and the State Board of Equalization more difficult.

(g) Changes in ownership may not trigger reassessment because of leasehold interests that are not transparent to the assessor.

(h) Therefore, it is the intent of the Legislature to provide all of the following:

(1) Greater clarity with regard to those circumstances in which a change in ownership has occurred.

(2) Greater transparency in ownership patterns with respect to the filing of deeds and with respect to other real property and financial transactions.

(i) It is further the intent of the Legislature that changes in ownership in which 100 percent of the ownership of a business, whether through mergers, private equity buyouts, transfer of ownership from one financial institution to another, transfers of shares of limited liability companies or trusts, transfers of partnership shares, or other changes by which 100 percent is transferred shall constitute a change of ownership subject to reassessment.

Related to the LEOP COS required to be filed with the BOE, this bill:

**Notification to Assessors.** Adds Section 480.9 to the Revenue and Taxation Code to require the BOE to notify assessors when a change in ownership or change in control occurring under proposed Section 64(c)(1)(B) occurs. §480.9

**Penalty.** This bill amends Sections 480.1, 480.2, 482 to increase the penalty if a person or legal entity does not file a LEOP COS with the BOE from 10% to 20%.

#### IN GENERAL

**Property Tax System.** Proposition 13 approved by voters in 1978 substantially changed the property taxation system in California. In general, California's system of property taxation under Article XIII A of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the inflation rate, as measured by the California Consumer Price Index, or 2%, whichever is less, until the property changes ownership. At the time of the ownership change, the value of the property for property tax purposes is redetermined based on current market value.

**Change in Ownership.** While Proposition 13 provided that a “change in ownership” would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special Task Force - a broad based 35-member panel that included legislative and BOE staff, county assessors, attorneys in the public and private sectors, and trade associations - to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The Task Force findings are published in California State Assembly Publication 723, **Report of the Task Force on Property Tax Administration**, January 22, 1979. A second report, **Implementation of Proposition 13, Volume 1, Property Tax Assessment**, prepared by the Assembly Revenue and Taxation Committee, California State Assembly Publication 748, October 29, 1979, provides additional information on how changes in ownership would be determined under Proposition 13.

**Property Owned by Legal Entities.** One issue the Task Force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests in a legal entity that owns real property be considered a transfer of the real property interests and, thus, a change

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in ownership? The Task Force considered two alternatives; the “separate entity theory” and the “ultimate control theory”.

- **Separate Entity Theory.** The separate entity theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The ultimate control theory would look through the legal entity to determine who held the ownership interests and, thus, who had “ultimate control” of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The Task Force recommended that the separate entity theory be adopted for the following two reasons:

"(a) 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. 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.

(b) The ripple effects of ignoring the general separate entity laws of the state could not be predicted. The ultimate control theory threatened unknown disruptions of business organizations and practices. The separate entity approach avoids that pitfall by adopting the existing structure of corporate, partnership, etc. laws and building upon them."

The change in ownership definitions related to ownership interests in legal entities initially placed in statute in 1979 were based on the separate entity theory as recommended by the Task Force. However, thereafter, subdivision (c) of Section 64 was added which provided that a change in ownership occurred whenever there was a change in control by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity.

According to **Implementation of Proposition 13**, Assembly Publication 748, subdivision (c) of Section 64, "the majority-takeover-of-corporate stock" provision, was added "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 certain transfers among 100% wholly-owned corporations<sup>2</sup>."

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**Tax Burden.** The Task Force was concerned that because commercial and industrial property changes ownership less frequently than residential property, a shift in tax burden to residential taxpayers could occur. The definitions originally proposed for legal entities (based on the separate entity theory) were chosen to mitigate administrative difficulties. Because of this concern, the Task Force proposed that the Legislature study the idea of a constitutional amendment to periodically appraise commercial and industrial property at current market value noting:

"[s]uch a constitutional change would also result in far greater simplicity in the treatment of legal entities. If commercial and industrial properties were to be periodically reappraised for reasons other than change in ownership, the difficult and controversial policy issues in choosing between the 'ultimate control' approach or 'separate entity' approach, outlined previously, would largely be avoided. The Task Force commends the principle of such a change to the Legislature for additional study."

**Change in Ownership Discovery.** Revenue and Taxation Code Section 255.7 requires that whenever a change in ownership is recorded, the county recorder must provide the assessor with a copy of the transfer ownership document as soon as possible. Assessors discover most changes in ownership of real property via grant deeds or other documents recorded with the county recorder. However, real property owned by a legal entity may undergo a "change in ownership" as discussed above, but no grant deed or other document will be recorded that could alert the assessor that the property should be reassessed. Discovery of these types of changes in ownership, unlike transfers of real property, require the BOEs direct participation and self reporting by the legal entities.

**LEOP.** As noted above, independent discovery of reassessable events involving legal entities by property tax administrators is difficult because ordinarily there is no recorded deed or notice of a transfer of an ownership interest in a legal entity. Because of these difficulties, the law requires that the BOE participate in the discovery of changes in ownership and changes in control of legal entities under Section 64(c) and (d).

The BOE participates in this discovery task through a program called the Legal Entity Ownership Program (LEOP). The BOE's LEOP unit was started in January 1983 as a result of Chapter 1141 of the Statutes of 1981 (AB 152) to help in this discovery process. Under the LEOP, the BOE:

- Receives a list from the FTB of legal entities that have reported a change in control or change in ownership on their income tax returns.
- Monitors business publications, such as *Mergers & Acquisitions* and the Wall Street Journal.
- Receives referrals from assessors as a result of information obtained in local publications or business property statement filings.
- Sends a LEOP COS called the "Statement of Change in Control or Ownership of Legal Entities" to each entity.

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<sup>2</sup> Section 64(b) excludes transfers of ownership interests between affiliated corporations and Section 62(a)(2) excludes transfers which result in a change in the method of holding title to real property while the proportional ownership interests remain unchanged.

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- Analyzes completed LEOP COS's to determine whether there has been a change in control or ownership.
  - Notifies county assessors of changes in control and ownership.

**Annual Canvassing.** There is an annual canvassing of legal entities via the state income tax return which is required by Section 64(e). The questions on the California income tax form for corporations are as follows:

**J 1.** For this taxable year, was there a change in control or majority ownership for this corporation or any of its subsidiaries that owned or (under certain circumstances) leased real property in California? . . . . .  Yes  No

**2.** For this taxable year, did this corporation or any of its subsidiaries acquire control or majority ownership of any other legal entity that owned or (under certain circumstances) leased real property in California? . . . . .  Yes  No

**3.** If this corporation or any of its subsidiaries owned or (under certain circumstances) leased real property in California, has more than 50% of the voting stock of any one of them cumulatively transferred in one or more transactions since March 1, 1975, which was not reported on a previous year's tax return? . . . . .  Yes  No

**(Penalties may apply – see instructions.)**

The Franchise Tax Board (FTB) transmits to the BOE for further investigation the names and mailing addresses of the legal entities that report a change in control and/or a change in ownership on the income tax return. The BOE then makes a formal written request to the legal entity to file a LEOP COS to determine if property it owns in California should be reassessed.

The BOE also makes formal written requests to legal entities to investigate other possible changes in ownership based on information it obtains from monitoring business publications and referrals it received from local assessors or other sources. Additionally, at the local level, businesses are canvassed via the annual business property statement filed with the local assessor.

**Consequences of Ultimate Discovery.** There is a long term consequence of not reporting reassessable events promptly. This is because Section 531.2(b) and 532(b)(3) provide that when it is eventually discovered that a property should have been reassessed pursuant to Section 64(c) or (d) and it was not reported, then the property must be reassessed as of the date of that event and all the back taxes (plus interest and a potential fraud penalty) must be paid. Specifically, “escape assessments” are levied for every tax year in which the property owned by the legal entity was not assessed at the proper amount to reflect the change in ownership.

Generally, the statute of limitations provisions on escape assessments found in Section 532 limit escape assessments for prior tax years to either four or eight years. But due to concerns with intentional concealment of legal entity change in ownerships, provisions were enacted in the late 1990's to remove the statute of limitations to ensure there would be no financial advantage to concealing the event. Thus, Section 532(b)(3) requires that an escape assessment be made for every tax year when a legal entity fails to file the change in ownership statement, as required by Section 480.1 for a Section 64(c) change in control, or Section 480.2 for a Section 64(d) change in ownership.

**Guide to Change in Ownership Reporting Statutes**

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| <b>RTC Section</b> | <b>Subject</b><br><i>Click on link to view sample forms</i>                                                                                                                                                                                                                                                                    |
|--------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 64(e)              | <a href="#">State Income Tax Return Questions</a> <ul style="list-style-type: none"> <li>• Corporate – Form 100 - Question J</li> <li>• Partnership – Form 565 - Question T</li> <li>• LLC - Form 568 - Question O</li> <li>• Filed with FTB</li> <li>• FTB refers to BOE for Legal Entity Ownership Program (LEOP)</li> </ul> |
| 480                | <a href="#">Change In Ownership Statement (COS)</a> <ul style="list-style-type: none"> <li>• Transfers of Real Property</li> <li>• Filed with local county assessor</li> </ul>                                                                                                                                                 |
| 480.1              | <a href="#">LEOP COS</a> <ul style="list-style-type: none"> <li>• Transfers of Legal Entity Interests</li> <li>• Legal Entity Ownership Program (LEOP)</li> <li>• Change In Control under §64(c)</li> <li>• Filed with BOE</li> </ul>                                                                                          |
| 480.2              | <a href="#">LEOP COS</a> <ul style="list-style-type: none"> <li>• Transfers of Legal Entity Interests</li> <li>• Legal Entity Ownership Program (LEOP)</li> <li>• Change In Ownership under §64(d)</li> <li>• Filed with BOE</li> </ul>                                                                                        |
| 481                | COS and PCOR – Confidentiality                                                                                                                                                                                                                                                                                                 |
| 482                | Failure to File Penalties <ul style="list-style-type: none"> <li>• COS - §482(a) [Penalties related to §480]</li> <li>• LEOP COS §482(b) [Penalties related to §§480.1 and 480.2]</li> </ul>                                                                                                                                   |
| 483                | Failure to File Penalties – Penalty Abatement <ul style="list-style-type: none"> <li>• COS §483(a) and (b) [Penalties related to §482(a)]</li> <li>• LEOP COS §483(c) [Penalties related to §482(b)]</li> </ul>                                                                                                                |

**BACKGROUND**

**Related Legislation.** Legislation to (1) require annual reassessment of nonresidential property to its current market value via constitutional amendment and (2) redefine change in ownership as it applies to property owned by legal entities to current market value is summarized below.

| Year | Bill                                   | Summary                                                                                                                                                                                                                                                                                                                                  |
|------|----------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2010 | AB 2492 (Ammiano) – As Amended 5/18/10 | <b>Change in Ownership Definitions.</b> Substantively the same as this bill.                                                                                                                                                                                                                                                             |
| 2010 | AB 2492 (Ammiano) – As Amended 4/8/10  | <b>Change in Ownership Definitions.</b> Reassessment of property owned by publicly traded companies once every three years (rebuttable presumption). Property owned by other types of legal entities would be reassessed to current market value in proportion to the percentage of ownership interests in the legal entity transferred. |
| 2008 | AB 2461 (Davis)                        | <b>Split Roll – Revenue Estimate.</b> Required the BOE to conduct a study on the amount of revenue that would have been generated if nonresidential commercial property, as defined, had been reassessed at its fair market value.                                                                                                       |

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| Year | Bill                                     | Summary                                                                                                                                                                                                                                                                                                                                  |
|------|------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2005 | SB 17(Escutia) -As Amended               | <b>Change in Ownership Definitions.</b> Provides that a change in ownership occurs when more than 50% of the ownership interests in a legal entity (excluding publicly traded companies) are transferred to one or more persons or entities during a calendar year.                                                                      |
| 2005 | SB 17 (Escutia) - As Introduced 12/06/04 | <b>Change in Ownership Definitions.</b> Reassessment of property owned by publicly traded companies once every three years (rebuttable presumption). Property owned by other types of legal entities would be reassessed to current market value in proportion to the percentage of ownership interests in the legal entity transferred. |
| 2003 | SB 17(Escutia)                           | <b>Change in Ownership Definitions.</b> Redefine change in ownership for nonresidential commercial and industrial property. (Legislative intent)                                                                                                                                                                                         |
| 2003 | ACA 16 (Hancock)                         | <b>Annual Reassessment.</b> Annual reassessment of nonresidential, nonagricultural property.                                                                                                                                                                                                                                             |
| 2003 | SB 3X (Escutia)                          | <b>Change in Ownership Definitions.</b> Redefine change in ownership for nonresidential commercial and industrial property. (Legislative intent)                                                                                                                                                                                         |
| 2002 | SB 1662 (Peace)                          | <b>Change in Ownership Definitions.</b> Reassessment of nonresidential property when cumulatively more than 50% of the ownership has been transferred. Broaden the state and local sales and use tax base and reduce both the state and local sales and use tax rate. (Legislative intent)                                               |
| 2001 | AB 1013 (Leonard)                        | <b>Change in Ownership Definitions.</b> Reassessment of property owned by a legal entity when more than 50% of the ownership shares transfer.                                                                                                                                                                                            |
| 2000 | AB 2288 (Dutra)                          | <b>Change in Ownership Definitions.</b> Reassessment of property owned by legal entity once every three years - Rebuttable presumption of change in ownership. Possible income tax credit to homeowners based on fair market value of homes from additional revenue. Reduce the sales and use tax rate by 0.25 percent.                  |
| 1991 | SB 82 (Kopp)                             | <b>Change in Ownership Definitions.</b> Reassessment of legal entities when cumulatively more than 50% of the ownership has been transferred.                                                                                                                                                                                            |

**Initiatives.** Various initiatives to establish a split roll have been pursued.

| Year | Result                   | Summary                                                                                                                                                                                                                                                                                                                                         |
|------|--------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2009 | Title and Summary Issued | <b>Split Tax Rate.</b> Increase extra .55% for nonresidential real property excluding commercial agricultural property.<br><b>Homeowners' Exemption.</b> Increase to \$14,000<br><b>Business Personal Property.</b> Exempt first \$1,000,000 in value from assessment. (Submitted by Roberta B. Johansen and Karen Getman)                      |
| 2009 | Title and Summary Issued | <b>Periodic Reappraisal.</b> Reassessment of nonresidential real property excluding commercial agricultural property once every three years.<br><b>Homeowners' Exemption.</b> Increase to \$14,000<br><b>Business Personal Property.</b> Exempt first \$1,000,000 in value from assessment. (Submitted by Roberta B. Johansen and Karen Getman) |
| 2005 | Dropped                  | <b>Annual Reassessment.</b> In part, requires annual reassessment of all nonresidential real property excluding property used for commercial agricultural production. (Submitted by Roberta B. Johansen and James C. Harrison)                                                                                                                  |
| 2005 | Dropped                  | <b>Split Tax Rate.</b> Increases the tax rate on commercial real property except commercial residential rental property by either .30% or .50%. (Submitted by Roberta B. Johansen and James C. Harrison)                                                                                                                                        |
| 2005 | Dropped                  | <b>Split Tax Rate.</b> In part, increases the maximum tax rate from 1% to 3% on nonresidential property; counties set the actual rate at no less than 2%. Limits the 1% tax rate on residential property to the first \$2 million. (Submitted by K. Heredia)                                                                                    |
| 2005 | Dropped                  | <b>Annual Reassessment.</b> Annual reassessment of all nonresidential real property excluding property used for commercial agricultural production and personal property exemption of first \$500,000.(Submitted by Lenny Goldberg)                                                                                                             |
| 2005 | Dropped                  | <b>Annual Reassessment.</b> Annual reassessment of all nonresidential real property excluding property used for commercial agricultural production and personal property                                                                                                                                                                        |

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| Year           | Result                                    | Summary                                                                                                                                                                                                                      |
|----------------|-------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                |                                           | exemption of first \$500,000. (Submitted by Wayne Ordos)                                                                                                                                                                     |
| 2004           | Signatures Collected & Initiative Dropped | <b>Split Tax Rate.</b> Increase tax rate to 1.5% nonresidential real property excluding property used for commercial agricultural production. Proponent: California Teachers Association & Rob Reiner                        |
| 1992 Prop. 167 | Failed 41.16% - 58.84%.                   | <b>Change in Ownership Definitions.</b> Addressed a number of tax related items, including a provision to modify the change in ownership definitions related to legal entities. Proponent: California Tax Reform Association |

Legislation to strengthen legal entity change in ownership reporting and discovery includes:

**SB 507 (DeSaulier) Stats. 2010, Chapter 708.** This California Assessors’ Association sponsored bill, related to legal entity change in control and change in ownership statements required to be filed with the BOE’ increased from 45 to 90 the number of days a legal entity has to report a change in ownership or change in control to the BOE.

**SB 816 (Ducheny) Stats. 2009, Chapter 622** This California Assessors’ Association sponsored bill established penalties in Section 482 when a legal entity does not self report a change in control or change in ownership under Section 64(c) or (d) to the BOE within 45 days of the event. §§480.1, 480.2, and 482

It also eliminated automatic penalty extinguishment when a legal entity initially failed to respond to a BOE written request to file a LEOP COS, but responded upon a second request within 60 days. §§482 and 483

**SB 17 (Escutia – 2005) and SB 17 (Escutia – 2003)** In addition to establishing a penalty if a legal entity does not file a LEOP COS with the BOE within 60 days after the date that a change in control or change in ownership occurs (since enacted by SB 816 in 2009), these bills would have also (1) required legal entities to provide information, records, and documents necessary to ascertain if the legal entity has undergone a change in ownership or change in control under Section 64 (c) or (d) upon the written request of the BOE or the assessor and (2) provided that the BOE or the assessor may issue subpoenas for the attendance of witnesses or the production of information or records, if any person fails to provide required information or records for the purpose of securing change in ownership information.

**COMMENTS**

- 1. Sponsor and Purpose.** This bill is sponsored by the author to trigger more frequent reassessments of property owned by legal entities.
- 2. What is a "split roll?"** Typically when the term "split roll" is used it means taxing certain types of property according to a different tax rate or standard of value. The term "split roll," when it used within the context of the existing property tax structure of Proposition 13 (Article XIII A of the California Constitution), is generally used to mean changing the law to trigger more frequent "changes in ownership" of property owned by legal entities by modifying the change in ownership definitions as this bill proposes. A true "split roll" is not possible without a constitutional amendment.
- 3. Modifying “Change in Ownership” definitions.** While Proposition 13 provided that a “change in ownership” would trigger reassessment, the phrase was not defined. Statutory language defines the term "change in ownership" and details

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various transfers that are included or excluded from "change in ownership." Therefore, statutory amendments could, arguably, modify those definitions initially established.

4. **Under current Proposition 13 change in ownership definitions, when companies (i.e., legal entities) that own real property are purchased, the real property owned by those companies will not necessarily be reassessed to current fair market value.**

**Scenario 1:** If one legal entity buys 100% of the ownership interests in another legal entity in a single transaction, then absent an exclusion, this will result in a **reassessment** of all the real property owned by the acquired legal entity. There has been a "change in control" of the acquired legal entity under Section 64(c). (The acquiring legal entity has obtained more than 50% of the ownership interest in the acquired legal entity.)

**Scenario 2:** On the other hand, if three **different** legal entities were to buy 100% of the ownership interests in that same legal entity in equal shares, there would not be a "change in control" of the acquired legal entity and therefore **no reassessment** of any of the real property owned by the acquired legal entity. This is because each new buyer only has a 33 1/3% ownership interest in the acquired legal entity and no one has control. In this example, the transaction does not meet the definition of a "change in control" and current law does not permit the reassessment of the property owned by the acquired legal entity.

In both scenarios, the acquired legal entity has entirely new owners, but only under Scenario 1 is reassessment triggered.

| Date   | Transaction                                                                                                                                                                                                                                                              | Reassessment                                                                                                                                                                                                                                                                                                        |
|--------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 5/1/12 | <p style="text-align: center;"><b>Scenario 1</b></p> <p>Established Company (EC) <b>buys 100% of the stock</b> in Startup Company (SC)</p> <p>SC owns 5 properties in various locations in California</p> <p>SC purchased properties in 1995, 2000, 2005, 2008, 2009</p> | <p style="text-align: center;"><b>EC Obtains Control of SC</b></p> <p><b>100% Reassessment</b> of all 5 properties owned by SC to their fair market value on May 1, 2012.</p>                                                                                                                                       |
| 5/1/12 | <p style="text-align: center;"><b>Scenario 2</b></p> <p>Three Venture Capitalists (VC<sub>1</sub>, VC<sub>2</sub>, VC<sub>3</sub>) <b>buy 100% of the stock</b> in Startup Company in equal shares.</p>                                                                  | <p style="text-align: center;"><b>Neither VC<sub>1</sub>, VC<sub>2</sub>, VC<sub>3</sub> Obtain Control of SC</b></p> <p><b>No Reassessment</b> of any property owned by SC</p> <p>Each of the 5 properties retain an assessed value based on the value of the property at the time it was first acquired by SC</p> |

5. **New Change in Ownership Trigger Point.** This bill adds a new event that would trigger a change in ownership reassessment with respect to ownership interests in legal entities. That is, if **100 percent** of the ownership interests in a legal entity are sold or transferred in a **single transaction**, that event shall be considered a change in ownership of the real property owned by the legal entity requiring a reassessment of the property owned by the legal entity. Currently, only if a particular transaction caused a “change in control” of the legal entity (i.e., pushing one person (or legal entity) up and over the 50% threshold) would the property owned by that legal entity be subject to reassessment. This bill would result in a 100% reassessment of the five properties owned by the Startup Company in Scenario 2 which otherwise would not occur under current law.
  
6. **Proponents of this bill note that the current system is inequitable and this bill would treat the transfer of ownership interests in legal entities more fairly.** Any transfer of **real property interests** by an individual results in a change in ownership absent applicable exclusion while generally transfers of **ownership interests in a legal entity** do not result in a change in ownership of property owned by the legal entity. For example:
  - Four individuals (A, B, C and D) each own a 25% interest in a property. Each time an individual sells his or her interest to another person a change in ownership of a 25% interest in the property is triggered.
  - If the same property is *owned by a legal entity* in which the same four individuals each own a 25% interest, a sale by an individual of his or her 25% interest in the legal entity will not cause a change in ownership of the property owned by the legal entity. This is true even if there is a complete turnover of ownership interests in a single event. Only if one person obtains control of the legal entity (defined as more than 50%) will a change in ownership be triggered. This bill provides that if 100% of the ownership interests in the legal entity transfer in a single transaction, the property owned by the legal entity will be subject to reassessment as a change in ownership.

The following table illustrates the above example as well as the assessment consequences of transfers of ownership interests in a legal entity that would occur under this bill. (Note: Only the first transfer that takes place on January 1, 2012, which is bolded, reflects the changes made by this bill. The other transfer examples are reflective of existing law.

| Date          | Transfer                                                                               | Reassessment to Market Value                                |                               | Reassessment to Market Value |
|---------------|----------------------------------------------------------------------------------------|-------------------------------------------------------------|-------------------------------|------------------------------|
|               |                                                                                        | <u>Current Law</u><br><i>Real Property Entity Interests</i> | <u>Legal Entity Interests</u> |                              |
| <b>1/1/12</b> | <b>A sells out to E<br/>B sells out to F<br/>C sells out to G<br/>D sells out to H</b> | <b>100%</b>                                                 | <b>0%</b>                     | <b>100%*</b>                 |
| 4/5/13        | E sells out to I                                                                       | 25%                                                         | 0%                            | 0%                           |
| 9/10/14       | F buys out G & H                                                                       | 50%                                                         | 100%                          | 100%**                       |
| 10/15/15      | F buys out I                                                                           | 25%                                                         | 0%                            | 0%***                        |

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| Date     | Transfer         | Reassessment to Market Value                                |                                              | Reassessment to Market Value               |
|----------|------------------|-------------------------------------------------------------|----------------------------------------------|--------------------------------------------|
|          |                  | <u>Current Law</u><br><i>Real Property Entity Interests</i> | <u>Current Law</u><br><i>Legal Interests</i> | <u>Proposed Law</u><br><i>Legal Entity</i> |
| 12/30/16 | F sells 50% to J | 50%                                                         | 0%                                           | 0%****                                     |
| 01/30/17 | J sells 25% to K | 25%                                                         | 0%                                           | 100%****                                   |

\* **All New Owners – But No One in Control.** Transfer of 100% of ownership interests in a single transaction. The new change in ownership trigger point created by this bill will result in a 100% reassessment of the property. Property will be reassessed to its fair market value as of the date of the transfer, which is January 1, 2012.

\*\* **Change in Control.** On September 10, 2014, F acquires “control” of the legal entity, with a total of 75% of the ownership interests in the legal entity. Current law requires a 100% reassessment. Property will be reassessed to its fair market value on September, 10, 2014

\*\*\* **No Change in Control.** F owns 100% of the legal entity as of October 15, 2015. But, since F previously obtained control of the legal entity on September 10, 2014, this is not a reassessable event.

\*\*\*\* **Loss of Control.** F owns 50% and J owns 50% -- no one has control of the legal entity. While F has lost control, no one has gained control, so this is not a reassessable event.

\*\*\*\*\***Three year period.** 100 percent of the ownership interests are sold or transferred within a three-year period

7. **Is the effect of the change in ownership provisions for legal entities an unintentional loophole?** The Proposition 13 Task Force considered and debated the issue of transfers of interests in legal entities and current change in ownership definitions were consciously made. The question appears to be whether the definitions are still appropriate after more than 25 years. The Task Force recognized the potential effect of these definitions over the long term noting "(t)he Task Force admits that some of its own recommendations, such as those regarding legal entities, while the best of a seemingly 'no-win' choice of options and adopted to mitigate administrative difficulties, may, in the long run, further exacerbate this [tax burden] shift to residential property because it will result in fewer potential commercial and industrial property transfers being recognized for reappraisal purposes." Consequently, the Task Force proposed that the Legislature might later study a constitutional change to periodically reappraise commercial and industrial property.
8. **In order to avoid reassessment, legal entities would likely, where possible, ensure that less than 100% of the ownership interests are transferred.** Currently, as long as no one person or legal entity acquires control, neither the timing of the ownership interest transfers nor the manner in which ownership interests are transferred is of particular importance for property tax purposes.
9. **This bill affects any type of real property owned by a legal entity.** Bills similar to this legislation are typically viewed in the context of commercial properties, but any

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type of real property owned by a legal entity (partnerships, limited liability corporations, corporations, etc.) would be subject to the new change in ownership definition. This bill could affect the assessment of single family homes, multi-family properties (such as apartments, duplexes and mobilehome parks), agricultural property, family farms<sup>3</sup>, and small businesses – whenever such types of properties are owned by a legal entity.

10. **“Original Transaction” is not defined.** In cases where a rolling three year period must be tracked, it would be necessary to identify the date of the “original transaction.”
11. **There could be some confusion when both Section 64(c)(1)(B) and Section 64(d) apply.** Section 64(d) currently states that when the transfer of ownership interests in a legal entity cause **both** a change in control under Section 64(c) and a change in ownership under Section 64(d), then property owned by the legal entity will be reassessed pursuant to Section 64(c). As presently constituted, it is unclear, when a change in ownership occurs under both Sections 64(c)(1)(B), and 64(d), under which of those two sections a reassessment would be made. If a reassessment is made pursuant to Section 64(d), then only the property owned by the legal entity that was previously excluded under Section 62(a)(2) would be reassessed. Whereas, if the reassessment is made pursuant to Section 64(c)(1)(B), then **all** the property owned by that legal entity would be subject to reassessment.
12. **Legal challenges of any new definition might be made on the grounds that different change in ownership definitions violate the Equal Protection Clause.** The U.S. Supreme Court has held in many cases that a differential system of taxation does not violate the Equal Protection Clause provided that the state legislature has a rational basis for such a system.

## **COST ESTIMATE**

The BOE would incur costs to administer this bill. An estimate of these costs is pending.

## **REVENUE ESTIMATE**

Existing property tax law specifies that a change in ownership occurs when a legal entity or other person obtains a controlling or majority ownership interest in the legal entity.

This bill would require any real property owned by a legal entity to be reassessed whenever 100 percent of the ownership interests in that legal entity are sold or transferred in a single transaction. This bill defines "single transaction" as a transaction in which 100 percent of the ownership interests are sold or transferred in either one calendar year or within a three-year period beginning on the date of the original transaction when any percentage of ownership interests are sold or transferred. Therefore, this bill would subject real property owned by legal entities to reassessment

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<sup>3</sup> The parent-child change in ownership exclusion does not apply to transfers of ownership interests in legal entities. However, it is possible to use the parent-child exclusion by using a multi-step process: (1) Property is transferred from the legal entity to the parent as an individual. (2) The parent transfers the property to the child. (3) If desired, the property may be transferred from an individual into another legal entity. There is a one million dollar cap (assessed value not market value) on the value of property that may be transferred without reassessment under the parent-child change in ownership exclusion.

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more often than would otherwise be allowed under current law. This would result in an increase in assessed value and an increase in property tax revenue.

It is not possible to estimate the resulting increase in property tax revenue with any degree of certainty. We do not have any information as to how many times such transactions occur in California. We do not know the current assessed value of real property owned by legal entities, nor do we know its current market value. We can however, attempt to make some assumptions with regard to the amount of property under consideration in order to give an indication of the order of magnitude of the revenue gain.

The assessed value of 2009-10 locally assessed real property was \$4.1 trillion. While we do not know how much property is owned in California by legal entities, with information received from property tax roll files from a small sample of counties, we estimate the portion of the assessed value that is owned by legal entities to be 23 percent, or \$943 billion.

The BOE does a study each year to determine the effective assessment level (i.e., the percentage difference between assessed value and market value) for commercial/industrial property in order to determine the assessment level for rail transportation property (the 4R Ratio). The latest study, based on information from the 2009-10 assessment roll, finds that the effective assessment level for locally assessed commercial/industrial property is about 80 percent. If we apply this ratio to the estimated assessed value of property owned by legal entities, we can estimate the current market value of property owned by legal entities to be:

\$943 billion / 80%, or \$1.2 trillion.

It is not possible to predict which properties owned by legal entities would be reassessed to current market value each year as a result of this bill. The legal entity change in control statements processed by the BOE do not capture information that would indicate the number of such transactions that have occurred in the past, nor are such transactions required to be reported. While we do not have information regarding the proportion of property that would be reassessed under this measure, the data that we do collect suggests that the proportion of assessed value to be reassessed would be very small. If we assume that 3 percent of property owned by legal entities will be subject to reassessment to current market value each year as a result of the new change in ownership definition created by this bill, the revenue impact at the basic 1 percent property tax rate would be:

| <b>Estimated</b>            | <b>Estimated</b> | <b>Estimated</b>          | <b>Estimated</b>           | <b>Estimated</b> |
|-----------------------------|------------------|---------------------------|----------------------------|------------------|
| Legal Entity Assessed Value | 4R Ratio         | Legal Entity Market Value | Increase in Assessed Value | Revenue Gain     |
| \$943 billion               | 80%              | \$1.2 trillion            | \$257 billion              | \$77 million     |

This bill would also increase the penalty for failure to file legal entity change in control statements with the BOE from 10 percent to 20 percent of taxes due. With approximately 30,000 statements filed during fiscal year 2008-09, assuming 1 percent

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of those statements were filed late and subject to penalty, and further assuming an average assessed value for property owned by legal entities to be \$300,000, we can estimate the revenue impact of increasing the penalty to file timely to be less than \$1 million annually. Additionally, as the increased penalty becomes a deterrent to late filing, this amount may decrease over time.

**REVENUE SUMMARY**

Based on the preceding assumptions, the annual revenue gain could amount to approximately \$77 million.

**Qualifying Remarks.** The revenue estimate is based on limited data. The estimate was prepared to give an indication of the order of magnitude of the revenue impact of this bill. The revenue impact will vary from year to year depending upon the number of such transactions in any given year. Further, the revenue impact could vary greatly depending upon the number of properties, and the value of such properties, actually owned by any legal entity that might be impacted because of this bill.

|                       |                   |              |                       |
|-----------------------|-------------------|--------------|-----------------------|
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