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THE NEXT LEVEL FINANCE

Prop. 13: The New Ownership Interest Transfer Reporting Requirement

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California recently adopted a strict new reporting requirement in an attempt to more rapidly and accurately identify real property that may have undergone a "change in ownership" by reason of transfers of ownership interests in entities directly or indirectly owning such real property. This reporting requirement is effective for transfers of ownership interests on or after January 1, 2010. Significant penalties are imposed for failure to report a transfer-of-ownership interest that is subject to the new requirement.

Background

Real property is assessed annually in California based on its actual value as of January 1 of each year. But under Proposition 13, passed by California voters in 1978, such assessed value is limited to its so-called base-year value, increased annually by the inflation rate, as measured by the California Consumer Price Index, or 2 percent, whichever is less.

A new base-year value is established — reset to actual market value — whenever a property undergoes a change in ownership, most commonly when the property is sold or otherwise transferred to a new owner. However, as described here, in the case of real property owned directly or indirectly by an entity as opposed to a "natural person" a change in ownership may also occur as a result of transfers of ownership interests in such entities.

Because transfers of ownership interests in a corporation, partnership or limited liability company do not involve a recorded deed, they have been more difficult for the assessor to identify. Moreover, the Proposition 13 limitation on increases in assessed value as

applied to long-term ownership of real property by corporations, partnerships and other entities means that a change in ownership may result in a significant increase in the assessed value of property even under the current adverse market conditions.

History of Reporting Transfers

Unlike a Preliminary Change in Ownership Report, or PCOR, filed in connection with a transfer of real property, prior to 2010 neither the transferor nor the transferee of ownership interests in an entity that owned real property in California was affirmatively required to report the transfer at the time the it occurred.

However, standardized "yes or no" questions on annual California entity tax returns filed with the Franchise Tax Board typically identified, albeit significantly in arrears, if a reassessment event may have occurred by reason of an ownership interest transfer, assuming, of course, that the tax return questions were answered correctly.

The FTB would forward the name of any entity affirmatively responding to these questions to the State Board of Equalization (SBE), which would then send the entity a Form BOE-100-B, Statement of Change in Control and Ownership of Legal Entities, to be completed and returned to the SBE.

The New Filing Requirement

Under the new law, if an entity or any legal entity under its ownership control owns an interest in California real property — for this purpose, an interest in real property includes the lessee's interest under a lease of California real property having a remaining term of 35 years or more — any transfer of an ownership interest that results in a change in control or a change in ownership of such entity must be reported to the SBE by the

person or entity acquiring such ownership interest within 45 days of such transfer.

Reporting of a change in control is required even if an applicable exemption would prevent the transfer from constituting a change in ownership. The SBE has implemented the new law by requiring the acquiring person or entity to file with the SBE within the applicable 45-day period a slightly modified version of Form BOE-100-B (the form can be viewed at <http://www.boe.ca.gov/proptaxes/pdf/boe100b.pdf>).

Change in Ownership and Change in Control

Assuming no exemption applies, transfer of ownership interests in an entity will constitute a change in ownership if there is either a change in control of such entity or the so-called original co-owner rule applies and the transfer results in the original co-owners' interests in the property being reduced below 50 percent.

A transfer of ownership interests in an entity will constitute a change in control if such transfer results in any person or entity acquiring, in the case of a corporation, direct or indirect ownership or control of more than 50 percent of the voting stock in such corporation; in the case of a partnership, direct or indirect ownership of more than 50 percent of the total interest in such partnership's capital and profits; and with respect to any other entity, direct or indirect ownership of more than 50 percent of the total ownership interest in such entity.

Thus, so long as one person does not acquire more than 50 percent control of an entity, more than 50 percent of the ownership interests in the entity may be transferred without causing a change in control.

However, if a previous transfer of real property or of ownership interests in a entity

would have resulted in a change in ownership or change in control but for the application of the exception for a mere change in the form of holding title in which the proportional ownership interests of the transferors and transferees remain exactly the same after the transfer of the property to a new single-member LLC or the insertion of a holding company or mezzanine entity between the property-owning entity and its owners, the change in control rules are replaced by the much more restrictive original co-owner rule.

Under the original co-owner rule, a snapshot is taken of the beneficial ownership of the property at the time of the exempted transfer, and a change in ownership of property will occur at any time when the interests in the property of such original co-owners is reduced below 50 percent. Thus, if the original co-owner rule were applicable to an entity, cumulative transfers of beneficial interests in the real property of more than 50 percent would cause a change in ownership of the real property even if such transfers would not otherwise be a change in control.

Penalty for Failure to File

Failure to file the Form BOE-100-B with the State Board of Equalization within the required 45-day period will result in an automatic penalty of either 10 percent of the taxes applicable to the new base-year value of the reassessed property if a change in ownership occurred, or if reporting is required but an exemption from reassessment is available, 10 percent of the value of the property for the current year's taxes as of the date the 45-day period expired. ■

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