

RECENT COURT DECISION UPHOLDS LOS ANGELES COUNTY ASSESSOR'S NEW INTERPRETATION OF DOCUMENTARY TRANSFER TAX ACT

To Our Clients and Friends:

On September 22, 2014, the Second Appellate District of the California Court of Appeal issued an opinion affirming a lower court's decision to impose a California documentary transfer tax (DTT) on the transfer of interests in a legal entity that owned real property indirectly through another legal entity, concluding that a change in ownership of the legal entity that resulted in a change in ownership of the real property for property tax purposes was a taxable event under the Documentary Transfer Tax Act (DTTA).

The opinion in *926 North Ardmere Ave., LLC v. County of Los Angeles* describes a series of transactions involving, over time, the transfer of an apartment building by a trust (Trust) to a wholly owned limited liability company (Ardmore), a transfer by the Trust of its interest in Ardmere to a "trust-owned partnership" (Partnership), a "distribution" of interests in the Partnership by the Trust to certain subtrusts of the Trust, and a "distribution" and "sale" of 45% of the interests in the Partnership to each of two other trusts formed for the grantor's two sons.

The Los Angeles County Assessor concluded that the transactions resulted in a change in ownership of the apartment building and reappraised the property on that basis. Ardmere paid the supplemental property tax assessment. Following the property tax reassessment, the Los Angeles County Registrar-Recorder/County Clerk, in an effort to enforce its new policy, demanded that Ardmere pay DTT, asserting that the change in ownership for property tax purposes also gave rise to liability under the DTTA.

California Documentary Transfer Tax Act

The California Legislature enacted the DTTA in 1967. Relevant to the instant case are sections 11911 and 11925 of the Revenue and Taxation Code (R&T Code). Section 11911 authorizes California 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" Section 11925 provides that, in the case of realty held by a partnership or other entity treated as a partnership for federal income tax purposes, no DTT is imposed as a result of a transfer of an interest in the partnership or other entity as long as certain requirements are met (namely that the tax partnership continues to hold the property and no termination of the tax partnership occurs under section 708 of the Internal Revenue Code). While the *Ardmore* opinion alluded to other provisions in the DTTA, it focused primarily on sections 11911 and 11925.

California Property Tax Provisions

Passed by the California electorate in 1978, Article 13A of the California Constitution provides that real property is reappraised for property tax purposes when a "change in ownership" occurs. The general rule under section 64(a) of the R&T Code is that transfers of interests in legal entities do not result in a change in ownership. However, section 64(c) and section 64(d) of the R&T Code provide exceptions to the general rule, meaning that certain transfers of interests in entities do result in a change in ownership of the underlying property. The *Ardmore* opinion states that Ardmore admitted in its discovery and in its appellate brief that the transactions resulted in a "change in ownership" of the property for property tax purposes.

The Court's Decision Imposing DTT

Based largely on its broad reading of two California cases addressing the DTTA in the context of long-term leases, the court determined that "realty sold" for purposes of the DTTA has the same meaning as "change in ownership" for property tax purposes, notwithstanding the significant differences between these two separate taxation schemes (transfer and ad valorem). According to the court, the only exceptions are those specifically identified in the DTTA, and the court determined that the exception in section 11925 of the R&T Code for transfers of interests in entities that are partnerships for income tax purposes did not apply because the apartment building was not owned directly by the Partnership; rather, it was owned by a limited liability company owned by the Partnership. The court alluded to but did not specifically address other exemptions in the DTTA. As a result, the court determined that the county could impose DTT as a result of the transactions.

"Realty Sold"

While some California jurisdictions, including San Francisco, have already amended their municipal codes to include as "realty sold" any acquisition or transfer of ownership interests in a legal entity that results in a change of ownership of the underlying property for property tax purposes, Los Angeles never amended its county or municipal code to link the DTT with the property tax change in ownership rules. Rather, according to testimony in the case, the Los Angeles County Recorder posted its new interpretation of the DTTA on its website, and in 2010 started assessing DTT on transfers that resulted in a change in ownership for property tax purposes.

The potential implications of the court's decision in *Ardmore* remain to be seen, but for the time being the risk of a documentary transfer tax being imposed upon transfers of interests in legal entities that own real property (including entities that own real property indirectly through other entities) previously thought to be exempt should be considered in any transaction involving a property tax change of ownership.

Please contact any Gibson Dunn tax lawyer for updates on this issue.

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Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have regarding these and other tax related developments. If you have any questions, please contact the Gibson Dunn lawyer with whom you usually work or any of the following:

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