
Presented at the Institute for Professionals in Taxation, Los Angeles Local Luncheon Group
February 19, 2014

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Fact or Fiction?

- California’s financial problems
- Press regularly blames Prop 13
- Rules for “commercial” property blamed for having loopholes
- Is what is reported true? Partially true? Completely false?
- Consider some quotes …
Real estate developers and commercial property owners have been gaming Proposition 13 since it was passed in 1978 .... The loophole has had a dramatic effect on the funding of government.

Ken Broder, AllGov.com
Proposition 13 has shifted the property tax burden away from commercial property owners and onto residential homeowners. This shift has taken place due to a loophole which allows companies to avoid reassessments when properties change hands, allowing them to pay taxes on assessed land values from years (and in some cases decades) ago. This practice is termed the “Dell Tax Maneuver,” after Michael Dell, who has avoided paying more than one million dollars a year in property taxes on a piece of commercial property he bought in 2006, but which is still taxed at its 1999 assessed value.

Citizens for Tax Justice, June 6, 2013
Over those 35 years, the property tax burden has swung from businesses to the homeowners that Proposition 13 was supposed to be protecting. ...Why? Because big businesses can game the word “ownership” in ways that are not possible for homeowners.

Patt Morrison, Los Angeles Times, LATimes.com, August 5, 2013
Democrats in the California Legislature have tried to close the loophole for several years but have met with strong opposition from business and taxpayer groups, which have labeled the bills “job killers.”

Jason Felch, Los Angeles Times, LATimes.com, May 7, 2013

[Link to article: articles.latimes.com/2013/may/07/local/la-me-dell-jarvis-20130508]
What the Mainstream Press Says ….

The measure also created loopholes that businesses exploit to avoid paying their fair share, says San Francisco Assemblyman Tom Ammiano, a 69-year-old Democrat who has sponsored legislation to tighten rules on business-property transfers.

Christopher Palmeri, Bloomberg.com, October 16, 2011

But large corporate property owners have been among the law's biggest beneficiaries, thanks in part to loopholes such as the one Dell used.

For the past two legislative sessions, [State Assemblyman Tom] Ammiano has sought to close what he and many others see as a loophole in Proposition 13’s treatment of commercial property. Even if an owner sells his entire interest in a piece of commercial real estate, the property is not reassessed if no single entity acquires more than a half-ownership stake. It is easy for corporations to structure deals to avoid a tax increase.

Mr. Ammiano thinks it’s an outrage that companies can skirt the intentions of the law when properties change hands.

“You have very large commercial enterprises, Wells Fargo, Wachovia, with this little sleight of hand in the way they structure ownership,” he said Wednesday in an interview. “It is very, very dishonest.”

What is a “Loophole”?

- Merriam-Webster defines “loophole” as “an error in the way a law, rule, or contract is written that makes it possible for some people to legally avoid obeying it,” and “an ambiguity or omission in the text through which the intent of a statute, contract, or obligation may be evaded.” (www.merriam-webster.com.)

- Cambridge Dictionaries Online defines “loophole” as, “an opportunity to legally avoid an unpleasant responsibility, usually because of a mistake in the way rules or laws have been written.” (dictionary.cambridge.org/us.)

- Oxford Dictionary Online defines “loophole” as “an ambiguity or inadequacy in the law or a set of rules.” (www.oxforddictionaries.com/us.)
What is a “Loophole”? 

The bottom line is that there is an error, ambiguity, or mistake in the way a law is written that allows a taxpayer to technically comply while skirting the law’s intent.

Is there a “loophole” in Prop 13?
Consider the Law

- Voter-approved ballot measure-added paragraphs to the California Constitution.
- Legislature adopted statutes.
- Board of Equalization promulgated regulations.
- Case law.
Prop 13 is enshrined as Article XIII A.

Caps maximum ad valorem taxes on real property to one percent of the property’s “full cash value” (fair market value).

Initially, after Prop 13’s passage, a property’s full cash value was the value on the 1975-76 tax bill.

Can only be reassessed upon the completion of new construction or when it changes ownership.

Locked in again for the new owner or with respect to the new construction.

Inflation factor max of two percent.
Task Force Report/Implementation Report

- California Assembly Revenue and Taxation Committee formed a Task Force to make legislative recommendations.
- Task Force Report details recommendations of how to define “change in ownership”.
- Implementation Report contains additional guidance on change in ownership/explains the evolution of the rules for legal entities.
Separate Entity vs. Ultimate Control Theories

- Task Force struggled with how to define “change in ownership” for property owned by legal entities.
- Separate entity theory.
- Ultimate control theory.
Rev. & Tax. Code § 64(a)

- The separate entity theory initially adopted by Legislature.
- Section 64(a) states the general separate entity principle:
  "[T]he purchase or transfer of ownership interests in legal entities, such as corporate stock or partnership or limited liability company interests, shall not be deemed to constitute a transfer of the real property of the legal entity."

- *Always been the law.*
- Loophole?
Rev. & Tax. Code § 64(c)(1)

- Legislature soon after adopted the ultimate control theory also.
- Section 64(c)(1) states the ultimate control theory.
- If a single person or entity obtains more than 50 percent direct or indirect ownership or control of an entity’s voting stock, or obtains more than 50 percent direct or indirect ownership of a partnership or limited liability company, there is a change in ownership of that entity’s property.
- Loophole?
Press only covers Rev. & Tax. Code § 64(c)(1), the “change in control” test.

Section 64(d) “original co-owner” rule.

If property is transferred to an entity in a proportional transfer after March 1, 1975, then the persons holding ownership interests in that entity afterward are “original co-owners.”

Cumulative transfers of more than 50 percent = change in ownership.

Applies regardless of whether a single person or entity obtains the interests, which is what is required in Section 64(c)(1).
Summary of the laws …

- Section 64(a) – separate entity rule, unless …
- Section 64(c)(1) – ultimate control rule, or
- Section 64(d) – original co-owner rule.

So what about this Dell case?
Ocean Avenue LLC v. County of Los Angeles

- Property is the Fairmont Miramar Hotel in Santa Monica.
- Property owned by Ocean Avenue LLC.
- Hotel Equity Fund VII, LP owned 100% of Ocean Avenue LLC.
- Put the Hotel up for sale in 2006.
- July 2006, contract entered into with 101 Wilshire, LLC, a company controlled by MSD Capital, LP – 99% of which is owned by Michael Dell – for 101 Wilshire to buy the fee interest in the Hotel.
- Purchase would result in 100% change in ownership of the Hotel.
Ocean Avenue LLC v. County of Los Angeles

- September 2006, the parties canceled the contract.
- Instead, they decided that Hotel Equity would sell off portions of Ocean Avenue LLC, the *entity*.
- 49% sold to trust for Susan Dell.
- 42.5% sold to entity owned 99.9999% by Dell.
- 8.5% sold to another LLC, owned by several entities, which were owned by several individuals and some by Dell himself.
- Dell obtained approximately 48% of the capital in Ocean Avenue directly and indirectly, and 44.6% of the profits directly and indirectly.
Ocean Avenue LLC v. County of Los Angeles

- Assessor originally agreed that the purchase was not a change in ownership, but county counsel persuaded otherwise, so Assessor reassessed it as a change in ownership.
- Ocean Avenue LLC appealed to the AAB and lost there.
- Ocean Avenue LLC appealed AAB decision to Superior Court, and won.
- Superior Court held that Section 64(a) applied, and 64(c)(1) and 64(d), the two exceptions, did not apply because no one person obtained > 50%, and the sellers weren’t original co-owners.
- Court also cited to Property Tax Rule 462.180, Example 7.
Property Tax Rule 462.180, Example 7 sets forth the rule of no attribution of interests between spouses:

Spouses H and W acquire as community property 100 percent of the capital and profits interests in an LLC which owns Blackacre. Each of H and W is treated as acquiring 50 percent of the ownership interests as defined in subdivision (c) of this rule and Revenue and Taxation Code section 64, subdivision (a). Since the selling members of the LLC are not original co-owners (because they did not transfer the property to the LLC under the Revenue and Taxation Code section 62, subdivision (a)(2) exclusion), no change in control of the LLC would occur under Revenue and Taxation Code section 64, subdivision (c) and no change in ownership of Blackacre under Revenue and Taxation Code section 64, subdivision (d).
Commercial vs. Legal-Entity Owned

- The confusion in reporting rests on the myth that special rules exist for “commercial” property that don’t apply to residential.
- Confuse owning commercial property with owning legal entities.
- **New York Times**: “Even if an owner sells his entire interest in a piece of commercial real estate, the property is not reassessed if no single entity acquires more than a half-ownership stake.”
- **San Francisco Chronicle**: “Under the law, an assessment is triggered only if a single entity owns more than 50 percent of the property – a loophole that many corporations easily circumvent, robbing the state of billions of dollars in tax revenue.”

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1 nytimes.com/2011/07/03/us/03bcstevens.html?_r=0
2 blog.sfgate.com/nov05election/2013/04/14/what-third-rail-ca-democrats-support-changes-to-prop-13/
A Shift in Burden?

- Has there been a shift in relative burden from commercial assessment to more residential assessment as a result of Prop 13?

- *Los Angeles Times*: Homeowners used to pay 40% of the total property tax burden, now they pay 57%.


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1 latimes.com/local/la-me-cap-proposition13-20140130.0,244820.column#axzz2ruPHjuZ. See also articles.latimes.com/2013/aug/05/news/la-ol-proposition-13-taxes-20130805, and articles.latimes.com/2013/may/05/local/la-me-dell-property-20130505
A Shift in Burden?

- CTRA report shows that the percentage burden of residential assessment in Los Angeles County was the following, based on data from the Assessor:

  1975: 53.37% residential (three years before Prop 13)
  2009: 69.09% residential

- *Relative increase*: 29.45%
A Shift in Burden?

- The population in Los Angeles County increased 23.8% in just 30 of those 35 years, from 7,477,421 in 1980 (shortly after the beginning of Prop 13) to 9,818,605 in 2010 (the last Census).\(^1\)
- What was the real starting point figure in 1978-79?
- How much new construction is residential vs. commercial?
- Skewed because of the large number of ridiculously expensive homes?
- Causation? What was happening in years before Prop 13?

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\(^1\) census.gov/population/cencounts/ca190090.txt; quickfacts.census.gov/qfd/states/06/06037.html
A Shift in Burden?

- Los Angeles County, continued …
- The CTRA report uses 1975 as its base year to derive the 29.45% relative increase in residential assessment until 2009. In 1975, it was reported to be 53.37%.
- But in 1980, just after Prop 13 went into effect, residential assessment in Los Angeles County was 63%, and then in 2009 it was 69%.
- So wasn’t the shift already happening?
- Or did a large amount of the shift happen immediately upon Prop 13’s passage?
A Shift in Burden?

- CTRA report shows that the percentage burden of residential assessment in Imperial County (with one of the largest spreads) was the following:
  - **1975:** 26.31% residential (again, three years before Prop 13)
  - **2009:** 70.70% residential

- **Relative increase:** 168%

- The population increased 90% from 1980 to 2010, from 92,210 in 1980 (shortly after the beginning of Prop 13) to 174,528 in 2010 (the last Census).¹

- How much new construction is residential? Agricultural?

¹ census.gov/population/cencounts/ca190090.txt; quickfacts.census.gov/qfd/states/06/06025.html
A Shift in Burden?

- CTRA report shows that the percentage burden of residential assessment in Santa Clara County was the following:
  
  1977: 50.00%
  2009: 65.00%

- Relative increase: 30%
- This is interesting …
A Shift in Burden?

- Santa Clara County, continued …
- The CTRA report states that Santa Clara County’s population growth during this period was 80%, and employment growth was 200%. The report concludes that given this huge growth in employment, the relative burden should have stayed at least 50/50, and blames the “loopholes” for it not staying constant:

  “Although housing prices are high, one would expect that the substantial job generation which has occurred relative to population would mean that at minimum the share of commercial/industrial property tax would stay relatively constant at the 50/50 ratio seen in the beginning of this era.” (Page 8.)
A Shift in Burden?

- Santa Clara County, continued …
- Are those statistics true? …
- Population from 1980 till 2010 increased by 37.57%, not 80%, from 1,295,071 to 1,781,642.¹

¹ [www.census.gov/population/cencounts/ca190090.txt; quickfacts.census.gov/qfd/states/06/06085.html](http://www.census.gov/population/cencounts/ca190090.txt; quickfacts.census.gov/qfd/states/06/06085.html)
A Shift in Burden?

- Santa Clara County, continued …

- What about employment? Total non-farm employment in 1980 was 661,063, and in 2010 it was 865,069. But this does not consider where people work. Based on a 2011 commuting survey, the U.S. Census reports that in 2011 there were 835,675 resident workers in the county (down slightly from the census data), and that 12.9% worked outside the county. That means 727,873 residents of the county worked in the county. The U.S. Census also found that 209,000 people commuted into the county. That gives a total estimate of employment in the county of 936,873. That is an increase over the 1980 figure of county employment of 661,063 of 42%.

- Employment did not increase 200%, but just 42%.
A Shift in Burden?

- Santa Clara County, continued …
- So if population since 1980 increased just over 37.5%, and employment increased 42%, then there wasn’t a substantial increase in employment relative to population that would necessarily curtail the increases in residential assessment from booming house prices.
A Shift in Burden?

Isn’t this question just way more complicated than the statistics?

Other than office buildings, much commercial property has not kept pace with residential values in California.

Values of warehouse, low-rise office space similar to surrounding states, but not homes …

Population increases do not result in 1-for-1 employment increases.

Population increases result in increased residential assessment, but won’t have a corresponding dollar amount of associated commercial assessment.

Exempt property – universities, government, healthcare.
Reduced Revenues?

- Prop 13 – state took control over allocation of property taxes from counties and cities.
- Press and advocacy groups talk about destroyed tax base.
- How much has Prop 13 cost the state in terms of lost property tax revenue?
Reduced Revenues?

According to the California State Board of Equalization,\(^1\) county property taxes in 1978 before Prop 13 passed were $10.3 billion for the 1978-79 fiscal year, and dropped to $5.04 billion for the 1979-80 fiscal year once Prop 13 was implemented (due to the immediate rate drop and rollback in base to 1975 value).

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Property Taxes Collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978-79</td>
<td>$10.3 billion</td>
</tr>
<tr>
<td>1979-80</td>
<td>$5.04 billion</td>
</tr>
</tbody>
</table>
Reduced Revenues?

According to the Board of Equalization, for the tax year 2010-11, the most recent year of data, property taxes raised for local governments totaled more than $48.9 billion.

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</tr>
<tr>
<td>2010-11</td>
<td>$48.9 billion¹</td>
</tr>
</tbody>
</table>

Of course, this is not adjusted for inflation or population increases.

¹ www.boe.ca.gov/proptaxes/pd...
Reduced Revenues?

Adjusting for inflation, the 1979 and 1980 amounts collected were valued in 2011 dollars as follows:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Property Taxes Collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978-79</td>
<td>$31.91 billion</td>
</tr>
<tr>
<td>1979-80</td>
<td>$13.76 billion</td>
</tr>
<tr>
<td>2010-11</td>
<td>$48.9 billion</td>
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</tbody>
</table>

Reduced Revenues?

From 1978 to 2010, the population grew by 62.5% (using 1978 population for the 1978-79 roll since it is based on homes owned on January 1, 1978, and using 2010 for the 2010-11 roll for the same reason), and from 1979 till 1980, the population grew by 59.9%. Adjusting for population growth, property tax revenues were:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
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</tr>
</thead>
<tbody>
<tr>
<td>1978-79</td>
<td>$51.8 billion</td>
</tr>
<tr>
<td>1979-80</td>
<td>$22.0 billion</td>
</tr>
<tr>
<td>2010-11</td>
<td>$48.9 billion</td>
</tr>
</tbody>
</table>
Reduced Revenues?

- Property taxes collected in 2010-11 were only slightly less than in 1978-79 – at a time when property taxes were considered so high as to cause a taxpayer revolt! Thirty-two years later, they were down less than 6% from the “outrageous” high.

- Consider – taxes collected for 2010-11 fiscal year were 222% higher than after the first year Prop 13 went into effect.

- Consider that in 2010-11, there were many Prop 8 reductions because of the recession.