
Ocean Avenue LLC v. County of Los Angeles Affirmed; AB 2372 Passes Assembly

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On June 3, 2014, in a published decision, the California Court of Appeal for the Second Appellate District affirmed the Superior Court ruling in Ocean Avenue LLC v. County of Los Angeles, holding that even though 100 percent of an entity was sold, a reassessable change in ownership of the entity's real property did not occur because no one person obtained more than 50 percent of the entity. Assembly Bill 2372 would change that result by requiring reassessment of an entity's realty if 90 percent or more of its ownership interests were sold within a three year period, even if no one owner acquired more than 50 percent.

The Ocean Avenue LLC Case

Ocean Avenue LLC acquired the Fairmont Miramar Hotel (Hotel) in Santa Monica in October 1999, and continues to be the record owner of the Hotel to this day. Before September 2006, Ocean Avenue LLC was a wholly owned subsidiary of Hotel Equity Fund VII, L.P. In March 2006, Hotel Equity put the Hotel up for auction and MSD Capital LP, a company owned by Michael Dell, the founder and CEO of Dell, Inc., was the winning bidder. The parties initially entered into a purchase and sale agreement for MSD Capital to buy the Hotel from Ocean Avenue LLC, but then canceled it before closing. Instead of Ocean Avenue LLC selling the fee interest in the Hotel realty, Hotel Equity sold 100 percent of the interests in Ocean Avenue LLC as follows:

- 49 percent to Susan Dell's (Michael Dell's wife) separate property trust;
- 42.5 percent to MSD Portfolio, L.P.—Investments (MSD Portfolio), owned 99.9999 percent by Michael Dell; and
- 8.5 percent to Miramar Hotel Investor, LLC (Hotel Investor), owned roughly 68 percent by Michael Dell and 32 percent by unrelated third parties, through various other entities.

Counting his ownership interest by multiplying through his respective interests in MSD Portfolio and Hotel Investor, Michael Dell acquired approximately 48 percent of Ocean Avenue. Together, Mr. and Mrs. Dell had acquired roughly 97 percent of Ocean Avenue LLC.

Under the current Proposition 13 (Prop 13) change in ownership rule in R&TC § 64(c)(1), if a limited liability company owns California real property, that property is reassessed if a single person or entity obtains direct or indirect ownership of more than 50 percent of the company capital and profits.

Assessment Appeal and Superior Court

Even though two separate Assessor staff people calculated that neither of the Dells individually obtained over 50 percent of the Ocean Avenue LLC capital and profits, the Assessor concluded that a change in ownership of the Hotel occurred and reassessed the Hotel. Ocean Avenue LLC appealed, and the Assessment Appeals Board agreed that there was a change in ownership because Hotel Equity transferred all of its ownership rights to the Hotel by transferring 100 percent of Ocean Avenue LLC. The AAB found that the original purchase and sale agreement that was canceled transferred equitable title when it was entered into. The AAB also concluded that the three prongs of R&TC § 60 were satisfied—that is, the buyers obtained present beneficial interests in the Hotel that were substantially equal to the fee interest—and therefore a change in ownership occurred. In addition, the AAB concluded that Michael Dell controlled more than 50 percent of the capital invested in the purchase, and had a right to the profits including a preferred rate of return, so there was a change in control.

The Superior Court disagreed, holding that no change in ownership occurred because neither of the Dells individually acquired over 50 percent of the Ocean Avenue LLC capital and profits. The Superior Court pointed to State Board of Equalization Property Tax Rule 462.180, Example 7, which states that the interests of a husband and wife are not attributed to each other for purposes of counting the 50 percent threshold. The Superior Court rejected the County's substance over form argument, making clear that transfers of legal entity ownership interests are governed by the legal entity rules in R&TC § 64 and Property Tax Rule 462.180, and not the general rule under R&TC § 60 applicable to direct transfers of real property.

Court of Appeal

The Court of Appeal affirmed the Superior Court. The Court calculated Michael Dell's interest by multiplying through the multiple tiers of ownership at only 48 percent. Thus, Michael Dell did not obtain over 50 percent of the capital or profits of Ocean Avenue LLC, with the Court stating, "The flaw in the County's argument is that it never does the math." Thus, the Court concluded that a change in control under R&TC § 64(c)(1) did not occur and the AAB was wrong because it failed to follow the Property Tax Rules, which demand this result. The Court of Appeal also rejected the County's "substance over form" argument from the federal income tax laws and the county's "equitable conversion" argument.

The taxpayer's win in *Ocean Avenue LLC* may have minimal impact, however, because of pending legislation in Sacramento.

AB 2372, sponsored by Tom Ammiano (D-San Francisco) and Raul Bocanegra (D-Pacoima), would change the result reached in *Ocean Avenue LLC* for entity transfers occurring on or after January 1, 2015. The bill adds new R&TC § 64(c)(1)(B), which provides that a change in ownership would occur when cumulatively 90 percent or more of the ownership interests in an entity are transferred in a three year

period, starting with sales or transfers that occur on after January 1, 2015, even if no one owner obtains more than 50 percent.

AB 2372 passed the California Assembly 57-13 on May 29th and is currently scheduled for hearings before the Senate Revenue and Taxation Committee.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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