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California Supreme Court Expands Scope of California Documentary Transfer Tax

On June 29, 2017, the California Supreme Court held that a change in ownership under California property tax law caused an incidence of documentary transfer tax under Section 11911 of the California Revenue and Taxation Code (the Code) affirming the Court of Appeal's decision in *926 N. Ardmore Ave. LLC v. County of Los Angeles*.

To summarize, previously, in most counties and cities, documentary transfer tax was only imposed when a document was recorded, and transfers of interests in legal entities owning real property were not subject to documentary transfer tax. In several counties and cities in California, the localities had enacted specific ordinances imposing documentary transfer tax on certain transfers of interests in legal entities owning real property. As a result of the Court's decision, however, transfers of interests in legal entities owning real property in California are subject to documentary transfer tax in all 58 counties and in hundreds of cities that impose documentary transfer taxes, regardless of whether a document is recorded, to the extent that such transfers constitute a change of ownership for property tax purposes.

The case involves a partnership that was the sole member of an LLC that owned real property. The partnership triggered an "original coowner" change in ownership under the property tax law found in Code Section 64(d). Transfers of this type, not directly involving conveyances of underlying real property, had historically not been subject to documentary transfer tax. Under the plain language and historical interpretation of the documentary transfer tax, this transfer did not cause an incidence of transfer tax. Under a practice instituted in 2010 in Los Angeles County, the County nevertheless sought transfer tax for these types of transfers by sending taxpayers notices of amounts due. From 2010 to present, however, the County did not seek to collect those amounts if they were not voluntarily paid.

In this case, the taxpayer in *926 N. Ardmore* paid the documentary transfer tax and then claimed a refund. In its claim and in the courts below, the taxpayer argued that the documentary transfer tax applied only in two instances: (1) if there was a written instrument that transferred ownership of real property (see 11911 of the Code); or (2) if a partnership that directly owned real property terminated under IRC Section 708 (see 11925 of the Code). Both the District Court of Appeal

and the Supreme Court's 926 N. Ardmore decision only dealt with the first issue.

Los Angeles County argued that a documentary transfer tax was triggered if a transaction constitutes a "change in ownership" under property tax law. The county, along with many amici curiae representing other local government agencies, argued that this reading of section 11911 of the Code was consistent with other California Court of Appeal decisions which have held that defining the term "realty sold" in the Documentary Transfer Tax sections of the Code had essentially the same meaning as "change in ownership of real property" in the Property Tax portion of the Code.

Both the trial court and the Court of Appeal agreed with the county and upheld the assessment of the tax. On appeal to the California Supreme Court, the taxpayer argued that the documentary transfer tax laws should not be read together with the property tax statutes because they were in separate divisions of the Code and had different goals, histories, and functions. Numerous briefs by amici curiae were filed on both sides of the issue.

After determining that the case was "one of statutory interpretation," the California Supreme Court recognized that the text of the code section levying the documentary transfer tax, Section 11911 of the Code, "provides no clear answers." The court then looked at the section in context with the other provisions of the California Transfer Tax Act to resolve the ambiguity. The court found that Section 11925 "creates a conditional exemption from the documentary transfer tax for realty held by specified entities when interests in those entities are transferred. Its inclusion indicates the underlying scheme is one in which the transfer of an interest in a legal entity might otherwise result in a tax liability." The court concluded that "the critical factor in determining whether the documentary transfer tax may be imposed is whether there was a sale that resulted in a transfer of beneficial ownership of real property." And the court determined that Section 60 *et seq.* of the Code serves the same purpose.

In a strong, but lone dissent, Justice Leondra Kruger stated that the effect of the majority's decision was to "sweep into the DTTA's compass a considerable swath of entity interest transfers that bear little or no resemblance to ordinary sales of real property." Justice Kruger also noted that the majority was expanding the taxation of "ventures well beyond the statute's language and historical practice," stating that she "would leave it to the Legislature to determine the circumstances under which an entity interest transfer should result in a deemed sale of the entity's real estate, and how to calculate the tax due in those circumstances."

This decision surprised many practitioners in California, particularly those who generally agree with the dissent. Nevertheless, it is now the law of California.

Some localities already impose the documentary transfer tax in connection with the transfer of ownership interests in a legal entity that result in a transfer of beneficial interest in real property under California property tax law. This decision will surely expand the ranks of cities and counties applying the documentary transfer tax to entity interest transfers that constitute property tax changes in ownership. Taxpayers should review their transactions carefully and consult with counsel in light of this decision. Below are some basic FAQs:

- (1) Is the decision retroactive? Nothing in the decision directly notes whether it is retroactive or prospective. Rather, it appears to interpret the law as of 2009, when the facts underlying the decision occurred. We believe, therefore, that it is likely that some localities will attempt to retroactively collect tax for past transactions.
- (2) How far back can the counties/cities go? Generally the statute of limitations is 3 years from when the tax became delinquent under Code of Civil Procedure 338(a). This may vary, however, in some localities, for example, if they have specified different specific statutes of limitations.
- (3) Will penalties and interest apply? Most localities do not impose penalties or interest for late payment of transfer taxes, but some do.
- (4) If I received a demand for DTT months or years ago, do I have to comply now? This is a fact-specific question that must be determined based upon the time that has passed since the demand and the application of local law.

(5) How will “value” be determined for purpose of calculating the tax? Code Section 11935 provides that an ordinance enacted pursuant to state law may include an administrative appeal process or that the amount may be decided under state law. Some charter cities may have other procedures.

There are numerous other unanswered issues that will arise as a result of this decision. Greenberg Traurig’s state and local tax lawyers are available to discuss how to handle past transactions, current transactions or how to defend any notice of bill imposing the documentary transfer tax from a locality that you may have received.

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