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Executive Director

May 31, 2007

Mr.

Re: *Change in Ownership – Rescission of Transfer to LLC*

Dear Mr. _____ :

This is in response to the questions contained in your November 1, 2006 letter to Mr. Robert Lambert, Acting Assistant Chief Counsel, and questions you asked during our subsequent telephone conversations. In your letter, you asked whether a change in ownership occurred when Mr. David _____ (David) transferred title to real property to _____, LLC (LLC) in exchange for a 50 percent interest in the LLC. During our subsequent conversations, I informed you that the transfer resulted in a change in ownership of the real property because the transfer did not result solely in a change in the method of holding title in which the proportional ownership interests of the transferors and transferees in the property remained the same after the transfer. Therefore, you asked whether the parties could rescind the transfer and thereby reverse the change in ownership and reassessment consequences.

As discussed below, it is our opinion that if the parties rescinded the transfer, future assessments of the property would revert back to, and be based upon, the property's prior base year value with appropriate inflation factor adjustments. However, rescission only provides prospective relief from reassessment; no refund or cancellation of taxes is available for the period of time between the date of the transfer and its rescission.

Background and Facts

Based upon your letters, documents, and conversations with you and Ms. _____ of the Los Angeles County Assessor's office, I understand the facts to be as follows.

On or about September 15, 1999, David's parents and five brothers acquired the real property at issue. David's parents, as trustors, held a 50 percent interest in the real property through Trust A and Trust B, revocable trusts, which each held 25 percent interests in the real property, during their lifetimes. David was the sole beneficiary of the trusts. David's five brothers owned the other 50 percent interest in the real property in proportionate shares, which were simultaneously transferred to the LLC at the time of acquisition in exchange for

proportionate 20 percent interests in the LLC; thus, as a result, Trust A and Trust B together held a 50 percent interest in the real property while the LLC held the other 50 percent interest in the real property with David's five brothers becoming original co-owners in the LLC. The LLC and the trusts held title to the real property as tenants in common.

In 2004, after David's last surviving parent passed away, the two trusts distributed their 25 percent interests to David, making David a 50 percent owner in the real property and a tenant in common with the LLC. Subsequently, David transferred his 50 percent interest in the real property to the LLC in exchange for a 50 percent interest in the LLC. After the transfer of his 50 percent interest in the real property to the LLC, the LLC (which previously owned the other 50 percent interest in the real property), now owned 100 percent of the real property. In addition, because David obtained a 50 percent interest in the LLC, each of his brother's original interests in the LLC was reduced from 20 percent to 10 percent accordingly. Finally, David's newly acquired 50 percent interest in the LLC allowed David to indirectly own interest in the portion of the real property previously owned by the LLC but not by David.

A quitclaim deed was recorded on March 25, 2005, confirming David's transfer of his portion of the real property to the LLC. Subsequently, the Los Angeles County Assessor's office re-assessed the value of the property due to the change in ownership consequences of the transfer. An appeal was filed, and an appeals hearing was scheduled for December 7, 2006. On November 1, 2006, however, prior to the appeals hearing, you requested our legal opinion regarding whether the county assessor properly reappraised the real property when David transferred his share of the real property to the LLC. I confirmed by telephone that the county assessor's reappraisal of the real property was appropriate for the reasons outlined below. Based upon this opinion, you dismissed the appeal.

In further conversations with you, you mentioned that David and the original members of the LLC did not intend to cause a change in ownership of the real property. You believed David's transfer of his portion of the real property in exchange for a 50 percent ownership in the LLC would be excluded from change in ownership under Revenue and Taxation Code¹ section 62, subdivision (a)(2) as a proportional transfer. Because the transfer did not reflect the parties true intentions, you asked whether the parties may rescind the transaction to reverse the reappraisal and change in ownership consequences.

Law and Analysis

Change in Ownership

As stated above, there was a change in ownership when David transferred his interest in the real property to the LLC because the LLC ended up with fee simple ownership of the whole property, while David received a 50 percent interest in the LLC and the original LLC members' interests in the LLC were reduced from 20 percent to 10 percent. This transaction resulted in a change in ownership because the percentage interests in the property and the LLC of both the

¹ All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

transferor and the transferee before and after the transfer were not proportional in accordance with section 62, subdivision (a)(2).

Section 60 defines a "change in ownership" as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." When an individual transfers real property to a legal entity, such as a limited liability company, the transfer is considered to be a change in ownership and results in reappraisal of the property transferred (Section 61, subd. (j); Property Tax Rule² 462.180, subd. (a)), unless the transaction qualifies for an exclusion from change in ownership.

Section 62, subdivision (a)(2) provides for an exclusion from the definition of change in ownership for certain transfers between an individual and a legal entity. To qualify for the exclusion, transfers must result solely in a change in the method of holding title to the real property, and the proportional ownership interests of the transferors and transferees must remain exactly the same before and after the transfer in each and every piece of real property transferred. (Section 62, subd. (a)(2); Rule 462.180, subd. (b)(2).)

In order for a transfer of real property from one individual to a limited liability company to be proportional, the transferor must own 100 percent of the same real property or portion thereof that the transferor owned prior to the transfer through the transferor's interest in the limited liability company. (Rule 462.180, subd. (b)(2).) However, there are only two ways for one individual transferor to own 100 percent of the same real property before and after a transfer to a limited liability company. The transferor must either own 100 percent of the limited liability company or 100 percent of the capital and profits from the transferred real property after the transfer. If the transferor owns less than 100 percent of the limited liability company and less than 100 percent of the capital and profits from the transferred real property, the transferor will own less than 100 percent of the transferred real property after the transfer, and the rest will belong to the other members of the limited liability company. This will result in a disproportionate transfer.

On the other hand, if one individual transfers real property or a portion thereof to a limited liability company that already has two or more members, then the transfer cannot be proportional unless the limited liability company issues the transferor a series or class of interests giving the transferor 100 percent ownership of the capital and profits from the transferred property. If this is not done, the transfer will automatically give the non-transferee members some interest in the transferred real property or a portion thereof (which the non-transferee members did not own prior to the transfer) due to the fact that the non-transferee members own interests in the capital and profits of the limited liability company. (See Property Tax Annotation³ (Annot.) 220.0375.025 (March 29, 2002); and Annot. 220.0375.030 (April 11, 2005).) Therefore, a transfer of real property to a limited liability company that has two or more existing members will only be proportional if all the members were co-owners of the transferred

² All subsequent references to "Rules" are to the Property Tax Rules promulgated under title 18 of the California Code of Regulations.

³ Property tax annotations are summaries of the conclusions reached in selected legal rulings of State Board of Equalization counsel published in the State Board of Equalization's Property Tax Law Guide. (See Cal. Code Regs., tit. 18, § 5200 for more information regarding annotations.)

property prior to the transfer, or if all the transferors receive a series or class of interests giving them 100 percent ownership of the capital and profits from the real property after the transfer.

In addition, the acquisition of interests in an existing limited liability company may cause a change in ownership pursuant to Rule 462.180, subdivision (d). This is because the acquisition of more than 50 percent of a limited liability company's capital and profits causes a change in ownership with regard to real property held by the limited liability company, and there is an "original co-owner" rule that applies to transfers of real property to legal entities. (Section 64, subds. (c), (d).) Under the original co-owner rule, the transferors of real property to a limited liability company in a transfer excluded from being a change in ownership pursuant to section 62, subdivision (a)(2), become original co-owners of the ownership interest in the limited liability company. Then, if the co-owners transfer, cumulatively, interests representing ownership of more than 50 percent of the capital and profits of the limited liability company through one or more transactions, then the transfer will result in a change in ownership. (See Annot. 220.0453 (July 26, 2006).)

In this case, David owned 100 percent of his proportional interest in the real property before transferring it to the LLC with the five original members. After the transfer:

- The LLC owned 100 percent of David's original interest in the real property;
- David held a 50 percent interest in the LLC, which gave him indirect ownership of one-half of the real property David held before the transfer and indirect ownership in the one-half of the real property that the LLC originally owned (which he did not own prior to the transfer);
- In addition, each of the original LLC members' interests in the LLC was reduced from 20 percent to 10 percent to allow David a 50 percent interest in the LLC;
- Finally, like David, the original non-transferee members now indirectly own, not only 10 percent of the original real property held by the LLC, but also 10 percent of David's original real property (which they did not own prior to the transfer).

Accordingly, the transfer of the real property from David to the LLC did not result in the same proportional shares in the real property for each and every transferor and transferee before and after the transfer as required by section 62, subdivision (a)(2). Hence, a change in ownership occurred with regard to David's 50 percent interest in the real property, and that property is therefore subject to reassessment.

Rescission

California law allows transfers of real property to be rescinded. Once a transfer is rescinded, the transferred property will be assessed as though the transfer was never made. However, rescission has only a prospective effect on the assessed value of real property. Any pre-existing tax liabilities or liens will not be cancelled as a result of a rescission.

Civil Code section 1688 et seq. provides for rescission of contracts, including contracts for the transfer of real property. Civil Code section 1688 states that "a contract is extinguished by its rescission." Civil Code section 1689 sets forth the grounds for rescission, while Civil Code section 1691 sets forth the procedures for effecting a valid rescission. Civil Code section 1691 provides that a party seeking to rescind a contract must give notice of the rescission to the other parties as to whom the rescission is to be effective and restore, or offer to restore, to the other parties all of the consideration which was received under the contract, upon the condition that the other parties do likewise, unless the other parties are unable or positively refuse to do so. (Civ. Code, § 1691, subd. (b).)

When a contract for the transfer of real property is rescinded based upon consent of the parties, rescission must be evidenced by a written notice of rescission signed by the parties to the contract, which should be provided to the assessor. At the same time that a rescission occurs, a rescission deed or a re-conveyance of title should also be recorded with the county recorder's office. The provisions of the Civil Code do not require court approval or a court order for rescission to be valid when the parties to the contract mutually agree to rescind. (See Annot. 220.0599 (C. June 29, 2001).)

Rescission of a transfer of real property relates back to the formation of a contract and dissolves it as though it had never been made. Thus, once a contract is rescinded by mutual consent, the parties are placed in the same position they were in before the contract was executed. The value of the real property reverts to its previous base year value with appropriate adjustment(s) for inflation. In other words, rescission returns the parties to their original positions prior to reappraisal of the subject property taking effect. (See Annot. 220.0595 (C. Jan. 16, 1985).)

However, in the context of property taxes, rescission has only prospective application; no refund of taxes is available to the parties for the period of time under which a conveyance is treated as a change in ownership, as the conveyance was effective for that period of time. (Annot. 220.0595 (C. Jan. 16, 1985).) This is so because property taxes are determined by the facts that exist as of the lien date or the date of change in ownership for the supplemental roll. (*Doctors General Hospital v. County of Santa Clara* (1957) 150 Cal.App.2d 53.) Therefore, rescission of a transfer of real property will not provide any relief from increases in property taxes already vested that have become liens on a property prior to the date of rescission. (See Annot. 220.0598 (C. February 8, 2001).)

Based upon the above, if David and the LLC mutually consent to rescind the transfer of the real property from David to the LLC, then, while rescission will reverse the reappraisal for future assessment rolls, it will not cancel any existing supplemental tax bills from 2006 or the assessment for the current year (2007).

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,

/s/ Denise L. Riley

Denise L. Riley
Tax Counsel

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cc: Honorable
County Assessor

Mr. David Gau	MIC:63
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70