

## REAL PROPERTY TAX ASSESSMENTS – UNCAPPING ISSUES

### I. INTRODUCTION

As a result of Proposal A, the taxable value of any parcel of real property cannot increase from one year to the next by more than the rate of inflation or five percent, whichever is less, until there is a “transfer of ownership.” When analyzing “transfers of ownership” in this context, two points are important to remember. First, a “transfer of ownership” for this purpose encompasses a number of transactions and events not traditionally viewed as real estate transfers (for example, certain stock transfers constitute “transfers of ownership”). Second, there are a number of transactions that traditionally would be viewed as real estate transfers but for this purpose are explicitly exempted from the definition of a “transfer of ownership.”

The rules for when and how the taxable value of real property becomes uncapped (*i.e.*, when there has been a “transfer of ownership”) are complicated. Moreover, the rules are not always logical.

For example: A husband can transfer his property to his wife without triggering an uncapping. Likewise, a husband can transfer property owned entirely by him to a limited liability company in which he is the sole member. However, a husband cannot transfer his property to a limited liability company in which his wife is the sole member. This last conveyance would result in an uncapping of the taxable value of the property. However, this couple could move the property from the husband to the wife’s limited liability company without triggering an uncapping by using a two-step transfer: that is, the husband would first transfer the property to his wife, and the wife, in turn, would transfer the property to the limited liability company in which she is the sole member.

As the above example illustrates, this is an area of the law which sometimes focuses on form over substance. This article will not endeavor to discuss all

of the various permutations of the uncapping rules. We will, however, discuss some of the basic rules as they relate to some of the more common commercial transactions. We will also attempt to point out some of the potential pitfalls. Remember that, once a transfer has taken place, there is no way to take it back. In the above example, for instance, if the husband had transferred the property directly to his wife's limited liability company, he could not go back and use the two-step process to avoid an uncapping. Thus, it is critical that the uncapping issue is carefully analyzed prior to any conveyance. For these reasons, a REALTOR® should ALWAYS refer clients with property assessment uncapping concerns to their attorney or their accountant before the deal is structured.

As an aside, savvy tenants with triple net leases often try to negotiate a provision whereby they are not responsible for any increase in real estate taxes caused by a "transfer of ownership." Tenants may argue that they should not be responsible for increased operating costs caused by a transfer of ownership over which they have no control. Obviously, including such a provision in a lease would make it more difficult for a landlord to sell its commercial property. Often times in this situation, the parties negotiate some type of compromise whereby the tenant is responsible for tax increases caused by transfers of ownership only a limited number of times during the life of the lease.

It is also important to keep in mind that a "transfer" for uncapping purposes is not the same as a "transfer" for state transfer tax purposes, or for that matter, for purposes of the county transfer tax. The meaning of "transfer" is different under all three statutes, and accordingly, the requirements of each statute must be analyzed independently.

## **II. DISCUSSION**

### **A. Ownership Changes in Legal Entities**

As many REALTORS® are aware, if a legal entity owns a parcel of land, transfers of interests in that legal entity can trigger an uncapping of the taxable value of that land. Specifically, the taxable value is uncapped when the ownership interest transferred exceeds 50%. What many REALTORS® may not know, however, is that the 50% rule is cumulative – *e.g.*, if a 25% interest was transferred in 2005 and a 26% interest was transferred in 2006, the 2006 transfer would trigger an uncapping of the taxable value of the property. Note that this would result in an uncapping of the total taxable value of the property, not just as to the 51% interest that had been transferred.

In the above example, if, after the taxable value of the property was uncapped as a result of a 2006 transfer, then would a transfer of another 20% interest in a subsequent year result in yet another uncapping? The answer to this question is “no.” Once the taxable value of the property is uncapped as a result of a transfer of more than a 50% interest, in effect the slate is wiped clean.

### **B. Leases**

Certain types of leases can trigger an uncapping of the taxable value of a parcel. If the term of the lease (including all options to renew) exceeds 35 years, the value is uncapped at the commencement of the lease. Likewise, the value of the property is uncapped at the commencement of the lease if the lease gives the tenant a “bargain purchase option.” A “bargain purchase option” is defined as the right to purchase the property at the termination of the lease for not more than 80% of the property’s projected cash value at the time of the termination of the lease.

If during the term of the lease, the tenant assigns its interest in the lease to another entity, that assignment will also trigger an uncapping if the remaining term of

the lease is more than 35 years. A transfer of ownership does not occur when the lease expires and the use of property returns to the landlord.

The rules do provide for a partial uncapping where the lease in question covers only a portion of the real property parcel. In other words, the assessor may only uncap the taxable value of that portion of the property that is subject to the long term lease.

### **C. Land Contracts.**

A sale by land contract will trigger an uncapping of the taxable value at the time the land contract is entered into. The taxable value is not uncapped again when the property owner gives a deed in fulfillment of the land contract.

If the seller assigns its interest in the property while the land contract is in place, there will not be an uncapping of the taxable value. If, however, the purchaser assigns its rights in the land contract, there will be another uncapping of taxable value.

But what if the land contract purchaser defaults and the land contract seller takes the property back? This will NOT result in an uncapping of the taxable value of the property. This does not mean, however, that in the event of a land contract forfeiture, the taxable value of the property will be returned to what it was before the land contract was signed. It just means that the taxable value will not be uncapped again. (If the seller takes the property back, the taxable value of the property will be uncapped again if the seller turns around and enters into a new land contract.)

### **D. Commonly Controlled Entities**

Property transfers between “commonly controlled entities” do not result in an uncapping of the taxable value. These rules are complicated and incorporate State and IRS rules for analyzing this issue in other contexts. Generally speaking, however, In order to qualify as “commonly controlled entities,” the entities must satisfy a two-part test:

1. The combined identical ownership of five or few individuals is greater than 50%; and
2. Five or fewer individuals together own at least 80% of both entities.

Consider the following example:

INDIVIDUAL OWNERS	ORGANIZATION(S) OWNED				
	V	W	X	Y	Z
A	50%	60%	40%	20%	60%
B	40%	15%	40%	50%	30%
C	--	--	10%	15%	10%
D	--	25%	--	15%	--
E	10%	--	10%	--	--
100%	100%	100%	100%	100%	100%

In the above example, entities V, X and Z above ARE “commonly controlled” because:

1. The combined identical ownership interest of individuals A and B exceeds 50%. (That is, A owns at least a 40% interest in each organization and B owns at least a 30% interest in each organization.)
2. Together, individuals A and B hold at least an 80% interest in each organization.

In the above example, entities V and Y are NOT “commonly controlled” because:

1. While individuals A and B’s combined identical ownership interest does exceed 50% (A owns at least 20% of V and Y, and B owns at least 40% of V and Y);
2. Together, A and B own only 70% of Y.

In the above example, entities W and Y are NOT commonly controlled

because:

1. While they satisfy the second test because individuals A, B and D together own at least 80% of both entities;
2. Individuals A, B and D's combined identical ownership interest does not exceed 50%. (A owns at least 20% of W and Y, B owns at least 15% of W and Y and D owns at least 15% of W and Y.)

Keep in mind, however, that this analysis only applies when you are comparing two entities. Treasury takes the position that where the transfer is from one or more individuals to an entity, the "common control" test is satisfied only when the transfer is to a separate legal entity that is owned by the same individuals **in the same exact proportions** as was the property itself. For example, there would not be an uncapping if Smith and Jones each owned a 50% interest in a parcel of land and then transferred it to an entity in which each held a 50% share. There would be an uncapping, however, if Smith held a 75% interest in the new entity and Jones had only 25%. Again, however, the same result could be accomplished using a two-step process so as to avoid an uncapping. That is, Smith and Jones could transfer their property to an LLC in which each owned a 50% interest, and then Jones could transfer a 25% interest in that entity to Smith.

As an aside, there is an entirely separate exemption for transfers between members of an "affiliated group." (An "affiliated group" means one or more

corporations connected to a common parent corporation by stock ownership. Entities which are not corporations cannot be part of an “affiliated group.”)

### **III. CONCLUSION**

This memorandum does not discuss all of the uncapping rules or even all of the permutations of the rules that are discussed. As shown from this discussion, the rules are complicated. (This is particularly true as to the “common control” tests.) Moreover, just because a particular transaction may result in an uncapping under one set of rules, doesn’t mean that there may not be another applicable exemption. REALTORS® should NOT use this memorandum to advise clients as to when or how the taxable value of property will be uncapped. REALTORS® should advise clients that there may be ways to structure transactions so as to avoid an uncapping of the taxable value of the property and then encourage these clients to discuss those options with their attorney or their accountant.