

Taxation of the Transfer of Single Member LLCs That Own Real Estate

HOLDING TITLE TO COMMERCIAL REAL PROPERTY in a single member, special purpose limited liability company is more common than ever and has transformed the manner in which commercial real property is transferred. In lieu of directly conveying title to the property itself, a buyer can purchase all the membership interests of the single member LLC. A lender that advances funds to the member of a single member LLC can take control of the property by foreclosing on the membership interests of the LLC if the loan is secured by those interests.

In California, transfer tax (which is distinct from property taxes) is collected when a deed or similar written instrument transferring ownership of real property is recorded.¹ When title to real property is held by a single member LLC, no document is recorded, and title never changes hands if interests in the single member LLC are transferred. Therefore, most California property owners and their advisers have historically treated the transfer of the membership interests of a single member LLC as exempt from transfer taxes. California cities and counties are starting to challenge this position, however, and trying to collect transfer tax on these transactions as they seek ways to increase tax revenues in a weak economy. Attorneys should be aware of recent efforts made by localities to expand the application of transfer taxes, as well as potential challenges to these efforts.

In November 2008, the San Francisco transfer tax ordinance was amended to broaden its scope to include the transfer of a controlling interest in a legal entity that owns real property. The amended San Francisco ordinance incorporates, by reference, the provisions of the California Revenue and Tax Code that relate to a change in ownership of a legal entity for property tax purposes.² In particular, the ordinance now incorporates Section 64 of the Revenue and Tax Code, which generally provides that real property owned by a single member LLC experiences a “change in ownership” and is reassessed for property tax purposes if any person obtains more than 50 percent of the ownership interests in the single member LLC.³

In Los Angeles, no such amendment has yet been adopted. However, the Los Angeles county recorder’s office is broadly interpreting its ordinance to include the transfer of a controlling interest in a legal entity. The recorder has stated that it believes that collecting transfer tax under these circumstances is already authorized in its local ordinance and by the provisions of the California Revenue and Tax Code that authorize cities and counties to impose transfer taxes.⁴ The county recorder also believes that it is consistent with case law to apply the principles of change in ownership as defined by California statute to determine whether the transfer of interests in a legal entity is subject to transfer tax.⁵

In the past, the sale or transfer of single member LLC interests would only result in a property tax reassessment. As result of the changes in San Francisco and Los Angeles, the transfer or sale of the membership interests of a single member LLC not only triggers a reassessment of the real property owned by the single member LLC but also causes transfer taxes to be assessed in these jurisdictions.

Property owners may be able to challenge attempts by cities and counties to collect transfer taxes on single member LLC transfers. The local transfer tax ordinance in jurisdictions such as Los Angeles is based on the California Act and case law interpreting the phrase “realty sold.” By exploring statutory and case law in more detail, property owners may be able to challenge attempts to collect transfer taxes on single member LLC transfers.

The California Tax Code

The California Tax Code authorizes localities to impose transfer taxes and is the starting point for determining whether the transfer tax applies to the sale or transfer of single member LLC interests. The California Act provides that transfer tax is imposed “on each deed, instrument, or writing by which any lands, tenements, or other realty sold within the county shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers, or any other person or persons, by his or their direction....”⁶

The California Tax Code also authorizes collecting the transfer tax when a partnership that holds real property experiences a technical tax termination for federal income tax purposes.⁷ Except for certain partnership terminations, the Tax Code does not contain any provision that specifically authorizes imposing the transfer tax on the transfer of ownership interests in any other type of legal entity.⁸

The California Tax Code is based on the federal Documentary Stamp Tax Act.⁹ The provisions of the federal act and applicable regulations suggest that certain partnership terminations are the only type of legal entity transfer within the scope of the transfer tax under the Documentary Stamp Tax Act.¹⁰ Thus, by inference, the scope of the California Tax Code should be similarly limited.

The language of the transfer tax ordinances of Los Angeles county and city are substantially similar to the California Tax Code. Both the county and city ordinances impose the transfer tax when a deed or similar instrument is recorded.¹¹ In addition, a partnership termination for federal income tax purposes is the only type of legal entity transfer addressed by the ordinances.¹² Like the California Tax Code, neither the Los Angeles county nor city ordinances contain any provision that authorizes the collection of the transfer tax on the transfer of ownership interests in any other type of legal entity.

Until the San Francisco transfer tax ordinance was amended, its terms were substantially similar to the terms of the California Tax Code and to the transfer tax ordinances of Los Angeles county and city. Prior to its amendment, the San Francisco transfer tax ordinance contained no direct authority for imposing transfer tax on a sale or transfer of interests in a single member LLC. The San Francisco ordinance only authorized collecting the transfer tax on a partnership termination. The San Francisco ordinance now contains a clear statement that the

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transfer tax will be applied to real property held by a single member LLC when a controlling interest in the single member LLC is transferred or sold.¹³ For those jurisdictions that adopt the California Tax Code or that have a transfer tax ordinance similar to Los Angeles city or county, a property owner can point to the local ordinance as lacking any authority for collecting transfer tax when interests in a single member LLC are transferred.

Cases Interpreting “Realty Sold”

The Los Angeles County Recorder also has stated that collecting transfer tax on the transfer of a controlling interest in a legal entity is consistent with case law that defines “realty sold” as having the same meaning as change in ownership for property tax purposes.¹⁴ Under the California Tax Code, cities and counties may collect transfer tax if the transfer of a controlling interest in a single member LLC constitutes realty sold.¹⁵ Although the phrase “realty sold” is key to imposing a transfer tax, neither the California Tax Code nor most local transfer tax ordinances define the phrase. It has been construed, however, in *Thrifty Corporation v. County of Los Angeles et al.*¹⁶ and in *McDonald’s Corporation v. Board of Supervisors*.¹⁷

In *Thrifty*, the issue before the court of appeal was whether a leasehold interest in real property can constitute “realty sold” and thereby trigger the transfer tax under the California Tax Code. In order to resolve this issue, the court of appeal first addressed whether leasehold interests are within the scope of the California Tax Code.

The court examined the provisions of the Documentary Stamp Tax Act to determine whether a leasehold can qualify as realty sold for transfer tax purposes. Regulations interpreting the act provide that real property leases generally are not subject to transfer tax. However, the transfer tax applied to a lease if it was of sufficient duration to approximate an interest in real property such as an estate in fee simple or a life estate. The court inferred that the state legislature intended to perpetuate the federal administrative interpretations of the Documentary Stamp Tax Act because the California Tax Code is patterned on the Documentary Stamp Tax Act and the California Tax Code employs language that is virtually identical to the Documentary Stamp Tax Act.¹⁸ The court concluded that certain long-term leases are within the scope of the California Tax Code and may be subject to transfer tax.

After determining that certain long-term leases are within the scope of the California Tax Code, the court needed to determine when a long-term lease is of sufficient duration for transfer tax to apply. To answer this question, the court found support in

California’s property tax provisions. While the California Tax Code does not define “realty sold,” the court of appeal held that the phrase was sufficiently similar to the phrase “change in ownership” as used in the state laws addressing when the base year value of real property is reassessed for property tax purposes.¹⁹ The court noted that the creation of a leasehold interest in real property for a term of 35 years or more (including renewal options) constitutes a “change of ownership” that triggers a property tax reassessment.²⁰ The court of appeal determined that the legislature intended the term “realty sold” to be defined consistently with the phrase “change of ownership.”²¹ In ruling that property tax change in ownership principles are the operative guidelines for determining whether the creation of a long-term leasehold interest constitutes “realty sold” for transfer tax purposes, the court of appeal noted that when the same term or phrase is used in a similar manner in two related statutes concerning the same subject matter, the same meaning should be attributed to the term in both statutes unless countervailing indications require otherwise.²²

In *McDonald’s*, the court of appeal also addressed transfer taxes in the context of a long-term leasehold, specifically whether the extension of a long-term lease was subject to the transfer tax and how to calculate the term of such lease for purposes of the transfer tax. Citing the *Thrifty* case, the court of appeal in *McDonald’s* also relied on property tax change of ownership principles to determine whether the transfer tax applied to the lease at issue.

Single Member LLC Transfers

Under the analytical framework of the *Thrifty* case, the initial inquiry in determining whether the transfer of a controlling interest in a single member LLC is subject to transfer tax is whether the transfer is within the scope of the California Tax Code. As in *Thrifty*, the scope of the California Tax Code is determined by examining the Documentary Stamp Tax Act.

Unlike the case with long-term leaseholds, no authority within the Documentary Stamp Tax Act holds that transfers of an interest in a single member LLC trigger a transfer tax. In fact, under the Documentary Stamp Tax Act, a partnership termination for federal income tax purposes is the only type of entity transfer that is subject to transfer tax. Although limited liability companies did not exist when the Documentary Stamp Tax Act was in effect, neither the Documentary Stamp Tax Act nor any of its interpretive regulations applied the transfer tax to the transfer of corporate stock. Given that the drafters of the Documentary Stamp Tax Act did not extend the application of the transfer tax to corporate interest transfers or any other type of legal entity transfer other than certain partnership

terminations, it may be inferred that the drafters of the Documentary Stamp Tax Act did not intend for the transfer tax to apply to the transfer of interests in any other type of legal entity. The California Tax Code should be interpreted consistent with the Documentary Stamp Tax Act. Consequently, the transfer of a controlling interest in a single member LLC is not within the scope of the phrase “realty sold” under the California Tax Code or any local transfer tax ordinance that is based on the California Tax Code.

Having determined that the transfer of a controlling interest in a single member LLC is not within the scope of the California Tax Code, it is irrelevant that the transfer of a controlling interest in a single member LLC may constitute a change in ownership for property tax purposes. In *Thrifty*, the court applied certain property tax change in ownership principles only after it concluded that certain long-term leases are within the scope of the transfer tax. As discussed above, the transfer of a controlling interest in a legal entity other than certain partnership terminations is not within the scope of the Documentary Stamp Tax Act, the California Tax Code, or any local transfer tax ordinance that is based on the California Tax Code. The Los Angeles County Recorder’s stated view that it is consistent with case law to define “realty sold” as having the same meaning as change in ownership in the case of a legal entity transfer ignores the first part of the *Thrifty* court’s analysis—a determination of whether the transfer of a controlling interest in a single member LLC falls within the scope of the California Tax Code. Arguably, single member LLC transfers are not within the scope of the code.

Owners of California real property should be alert to increasing efforts by county recorders and city clerks to collect transfer tax when a controlling interest in a single member LLC is transferred or sold. In San Francisco, the local transfer tax ordinance has been amended to expressly state that transfer tax will be imposed on real property owned by a single member LLC when interests in the single member LLC are transferred or sold. In jurisdictions where the local transfer tax ordinance has not been amended, such as Los Angeles, a property owner may challenge the collection of transfer tax on a single member LLC transfer on the grounds that 1) the local transfer tax ordinance does not contain any authority for the collection of transfer tax under such circumstances, and 2) the transfer of a controlling interest in a single member LLC is not within the scope of the California Tax Code or the local transfer tax ordinance. ■

¹ REV. & TAX. CODE §11911.

² SAN FRAN. BUS. & TAX REGS. CODE art. 12-C, §1114

(The term "realty sold" includes "any acquisition or transfer of ownership interests in a legal entity that would be a change of ownership of the entity's real property under California Revenue & Taxation Code [§] 64.").

³ See REV. & TAX. CODE §64(c)(1), which states in pertinent part:

When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities, including any purchase or transfer of 50 percent or less of the ownership interest through which control or a majority ownership interest is obtained, the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained.

⁴ REV. & TAX. CODE §§11901 *et seq.*

⁵ The following notice appears on the Web site of the Los Angeles County Registrar-Recorder/County Clerk (http://www.lavote.net/Recorder/Document_Recording.cfm): "The Los Angeles County Registrar-Recorder/County Clerk ('RRCC') began enforcing collection of Documentary Transfer Tax ('DTT') on legal entity transfers where no document is recorded, but which resulted a greater than 50% interest in control of the legal entity being transferred. The collection is made pursuant to Chapter 4.60 of the Los Angeles County Code, and California Revenue and Taxation Code ('RTC') sections 11911 and 11925, and is consistent with case law which defines 'realty sold' as having the same meaning as changes in ownership for property tax purposes in RTC section 64(c)(1). In addition, effective January 1, 2010, RTC section 408 was amended to allow recorders to obtain information pertaining to these transfers from the Assessor. As a result, in an effort to collect the tax, the RRCC will continue to identify, and send notices for, properties where a change of ownership occurred which transferred a greater than 50% controlling interest in the legal entity thereby creating a liability for the DTT."

⁶ REV. & TAX. CODE §11911(a).

⁷ REV. & TAX. CODE §11925(b).

⁸ See REV. & TAX. CODE §11925.

⁹ *Thrifty Corp. v. County of Los Angeles*, 210 Cal. App. 3d 881, 884 (1989). The Documentary Stamp Tax Act was repealed in 1976.

¹⁰ See 26 U.S.C. §§4361-4363, 4381-4384; 26 C.F.R. §§47.4361-47.4363-1, 47.4381-47.4384-1.

¹¹ L.A. COUNTY CODE §4.60.020; L.A. MUN. CODE §21.9.2.

¹² L.A. COUNTY CODE §4.60.080; L.A. MUN. CODE §21.9.8.

¹³ A question remains whether the amended San Francisco ordinance exceeds the authority granted by the California Tax Code.

¹⁴ See REV. & TAX. CODE §11911(a).

¹⁵ *Id.*

¹⁶ *Thrifty Corp. v. County of Los Angeles et al.*, 210 Cal. App. 3d 881 (1989).

¹⁷ *McDonald's Corp. v. Board of Supervisors*, 63 Cal. App. 4th 612 (1998).

¹⁸ *Thrifty*, 210 Cal. App. 3d at 884-85.

¹⁹ *Id.* at 886.

²⁰ *Id.* at 885.

²¹ *Id.* at 886.

²² *Id.*



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