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EARLELAW Newsletter

Real Property & Transfer Taxation

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Recently, a new client, R.E. Investor, called and said he needed help with a real estate matter. When he came to the law office, R.E. Investor said he usually doesn't hire lawyers because lawyers are too expensive and, besides, unless he's involved in litigation, he would rather do the work that he otherwise would have to pay a lawyer to do for him. R.E. Investor conceded that it sometimes takes him longer than it would take a lawyer to perform various legal tasks, but added that the money he saves in legal fees is worth the extra time he spends doing his own legal work. And, R.E. Investor added, he learns a lot with each new legal task he undertakes.

But now, R.E. Investor said, he has a legal problem that he has been unable to solve and with which he would just like "a little guidance."

R.E. Investor: As a real estate investor, my goals include acquiring and holding residential properties which have a "positive cash flow", that is, properties which rent for more than the monthly expenses, or, on the other hand, "negative cash flow" properties in which the appreciation in value over time is significantly greater than the total of monthly rental losses. I try to balance my real estate portfolio so that, as between my positive cash flow properties and my negative cash flow properties, my overall net monthly cash flow is positive or at least break-even.

Attorney: That strategy sounds good in principle. It provides for an overall net profit, while also seeking to minimize costs by not incurring unnecessary expenses. So tell me what has happened, or is happening now, that has caused you to seek my guidance?

R.E. Investor: The reason I have worked so hard over the years to build a real estate portfolio is so that I can provide my children and grandchildren

with a little something after I'm gone. So, in addition to simply acquiring wealth through real estate investments, I want to protect the assets that I acquire.

I recently attended a weekend asset protection seminar. Although attending the seminar was quite expensive, the cost of the seminar was still less than the cost of hiring an attorney to set up an asset protection plan for my real estate portfolio.

In a nutshell, the seminar presenter, an attorney, recommended that each investment property be held in a separate limited liability company. Alternatively, the seminar presenter suggested that multiple properties could be held in a single LLC.

Attorney: You went to an expensive seminar at which all the presenter did was recommend holding investment properties in LLCs?

R.E. Investor: Well, that's not all. As I mentioned, the presenter is also an attorney. As a benefit of attending the seminar, the attorney offered attendees a discount on legal fees for setting up LLCs. But I didn't fall for that. Instead, after leaving the seminar, I did a little research and then set up an LLC on my own, which saved me a significant amount of money.

I also attended a free seminar on living trusts and learned that by using a living trust, my estate can avoid paying large probate fees to the government. The presenter of the living trust seminar is also an attorney and, like the presenter at the asset protection seminar, offered attendees a discount on legal services.

After doing some research and then thinking about what I had learned, I decided to set up a living trust on my own. I purchased estate planning

documents over the Internet and prepared my own living trust.

Attorney: I assume you, during your lifetime, are the trustee of your living trust.

R.E. Investor: Yes. And after my death, my eldest son is to be the successor trustee.

Attorney: How did you structure the LLC?

R.E. Investor: As I mentioned, I invest in rental properties so that I will be able to leave something to my children and grandchildren. To facilitate this plan, I made my eldest son a non-managing member of my LLC, in addition to being the successor trustee of my trust.

Attorney: And now there is a problem?

R.E. Investor: Yes. Actually, there are a couple problems. After I set up the LLC, I transferred title of one rental property from myself to the LLC, so that the LLC would protect the property in the event someone brought a frivolous lawsuit against me.

After transferring the property to the LLC, I then placed the LLC into my living trust, so that the trust now owns the LLC, which, in turn, owns the rental property.

Then, because the rental property is located here in California, in the same county in which I reside, I personally took all of the deeds down to the county recorder's office to have them recorded.

That's when all the trouble started.

Attorney: Let me guess: The county now wants to reassess the property and raise your property taxes, and also wants you to pay a transfer tax for the transfer of the property from yourself to the LLC.

R.E. Investor: Yes. I'm afraid so.

Attorney: In 1978, California voters passed Proposition 13, which amended the California Constitution to provide, among other things, that real property in California may only be reassessed for the purpose of property taxation when there is either a change in ownership of the property or in the case of new construction.

A "change in ownership" is defined as "a transfer of a present interest in real property. . . ." California Revenue & Taxation Code § 60. A change in ownership will trigger a reassessment unless an exclusion applies.

A change in ownership is deemed to have occurred upon the transfer to an LLC, or to any other entity, of any interest in real property. 18 CCR 462.180. Reassessment, however, can be avoided upon a showing by the taxpayer of the existence of an applicable exclusion.

One such exclusion, known as the "Proportional Interest Exclusion," applies to transfers between an individual and a legal entity that results solely in a change in the method of holding title to real property and in which proportional interests of the transferor(s) and transferee(s) remain unchanged as a result of the transfer. R&T § 62(a)(2); 18 CCR 462.180.

R.E. Investor: All I did was transfer the rental property to my LLC, and then transfer my LLC to my trust. The Proportional Interest Exclusion should apply. Why does the county want to reassess my property and make me pay a transfer tax?

Attorney: First, the property was transferred from you to the LLC, which, by definition, is deemed to have been a change in ownership. Second, you, the taxpayer, have the burden of proving the applicability of any exclusion. Therefore, unless you can demonstrate the applicability of an exclusion, the property will be subject to reassessment.

You owned 100% of the rental property before the property was transferred to the LLC. Your eldest son, however, is a part owner of the LLC, which, in turn, means that your eldest son is a part owner of the rental property. Because your proportional interest (percentage of ownership) in the rental property changed when the property was transferred to the LLC, the Proportional Interest Exclusion does not apply.

R.E. Investor: What about the transfer tax?

Attorney: A similar proportional interest rule applies to transfer taxes. R&T § 11925(d).

R.E. Investor: It seems doing my own legal research was a good start, but that I should have consulted with an attorney prior to doing anything that altered my legal position.

Attorney: Exactly!

R.E. Investor: Perhaps the next topic we should discuss is my estate plan.

* Anthony F. Earle, Esq. represents individuals and small businesses in both litigation and non-litigation matters. Mr. Earle practices in the areas of business law, estate planning, family law, probate, real estate law, and trust administration.

Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Court of Appeals for the Ninth Circuit, and federal trial courts in the Northern District of California. He is a member of the American Bar Association and the Santa Clara County Bar Association.

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