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Bipartisan Assembly Bill Addresses Prop. 13 "Loophole"

Last month, the California Assembly passed AB 2372, a bill aimed at closing a "loophole" in California's Proposition 13 (Cal. Const. Art. XIII). Under Prop. 13, real property is reassessed to its current fair market value whenever a "change in ownership" occurs. With regard to entities, like a corporation, partnership or limited liability company, the transfer of stock or a partnership or membership interests is **not** a "change in ownership" unless the any one person or entity "obtains control" of 50% or more of the voting stock or ownership interest of the company.

This rule – which focuses exclusively on control – allows clever tax planners to avoid a costly reassessment by structuring transactions to ensure that no one person or entity acquires more than 50% ownership in the acquired entity.

For example, assume "X" is the sole owner of an LLC which owns an apartment complex in San Francisco. Rather than selling the apartment complex, X can sell his 100% membership interest to A, B and C. So long as neither A, B or C own more than 50% of the LLC, there is no change in ownership and no reassessment. However, if X sold his 100% membership interest to A, there would be a change in ownership because A would own more than 50% of the LLC after the transaction.

Please see *Prop. 13 Loophole* on page 3

"AB 2372 purports to close a "loophole" in Prop. 13 by changing the law to define a "change in ownership" as the sale or transfer of 90% or more of the ownership interests in a corporation, partnership or limited liability company in a 36 month period"

Costly and Burdensome New Accounting Requirements Affect Small Mutual Water Companies

AB 240 adopted new Corporations Code §14306. That section requires mutual water companies which operate a "public water system" to (1) adopt an annual budget in an open meeting before the state of each fiscal year, and (2) contract with a certified public accountant to conduct an annual review (subject to generally accepted accounting standards) of the financial records and reports of the mutual water company.

Please see *Mutual Water Companies* on page 2

Court of Appeals Holds Transfer Disclosure Statements Are Required for Mixed-Use Property

The recent case of *Richman v. Hartley* (2014) 224 Cal. App. 4th 1182, holds that a transfer disclosure statement (TDS) is required in the sale of mixed-use property containing four or fewer residential units, even if the transaction is primarily commercial in nature.

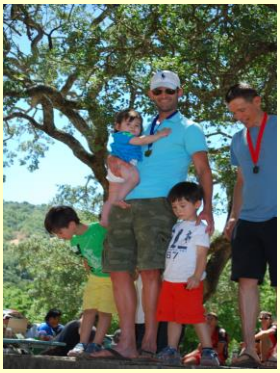
"The recent case of Richman v. Hartley (2014) 224 Cal. App. 4th 1182, holds that a transfer disclosure statement (TDS) is required in the sale of mixed-use property containing four or fewer residential units, even if the transaction is primarily commercial in nature.""

Under the facts of the case, in 2007, Richman entered into a contract to sell a single parcel of real estate improved with a commercial building and a residential duplex. The parties used an AIR form contract entitled "Standard Offer Agreement and Escrow Instructions for purchase of Real Estate (Non-Residential)." The AIR contract provided that "Seller shall make to Buyer, through escrow, all the applicable disclosures required by law." Escrow was to close two years later, in 2009.

Although left unsaid in the court's opinion, the real estate and financial meltdown undoubtedly made the sale much less attractive in 2009 than it was in 2007. Hartley refused to close escrow and Richman sued Hartley for breach of contract.

Hartley moved for summary judgment arguing that Richman's failure to deliver the TDS was a violation of the purchase agreement and precluded any action by Richman to enforce the agreement. The trial court agreed and the court of appeal affirmed.

Please see *TDS* on page 4



On June 29, 2014, I participated in my first mountain bike race in over 13 years. To my surprise, I finished in first place in the "expert" category. My kids loved the medal and were thrilled to participate in the podium awards.

Mutual Water Companies, from page 1

Section 14306 applies to mutual water companies which operate a "public water system," which is defined to mean any mutual water company which provides potable water to "15 or more service connections or regularly serves at least 25 individuals daily at least 60 days out of the year." Thus, many small mutual water companies are subject to the new requirements.

The accounting requirements can create headaches for a small mutual water company. The most obvious example is the requirement that the mutual water company retain a CPA to conduct an annual review of its books. In addition, in order to do this, the mutual water company will most likely need to prepare and keep its books in accordance with the same generally accepted accounting standards the CPA would use. Since most small mutual water companies use a more "informal" accounting and bookkeeping system, this means that in addition to hiring a CPA, there will be additional accounting costs incurred in simply preparing and keeping the books of the company. There is also uncertainly whether "generally accepted accounting standards" means the same things a generally accepted accounting principles (or GAAP). GAPP accounting standards are required of publically traded corporations, but they can be costly and burdensome for small corporations to follow.

On a Lighter Note … California's "Diarrhea" Sign Draws Well- Deserved Mockery and Rebuke

On a much lighter note … the California Building Code requires owners of public pools to post now fewer than 34 signs and notices around the pool or spa area. One such sign is drawing well deserved mockery and rebuke – the so-called "diarrhea" sign, which must be posted at the entrance to any public pool in language (or a diagram!) which clearly states that "persons having currently active diarrhea or who have had active diarrhea within the previous 14 days shall not be allowed to enter the pool water." The requirement applies to any public pool, even private community pools at apartment buildings or within homeowners associations.

The infamous "diarrhea" sign required at all public pools under Section 3120B of the California Building Code.

According to the California Apartment Association, "It is unreasonable to assume an apartment pool employee (assuming one exists) would ever approach a pool user and ask if they 'currently have active diarrhea or have had active diarrhea in the past 14 days. Most importantly, it would be ill-advised for an apartment pool employee to ever attempt to enforce this regulation as such action would almost certainly be the basis for charges of harassment by the pool user."

Critics also claim the signs address a non-problem, make a mockery of all signs in general, and have become a target for theft and vandalism. According to one critic, "Sharing a pool with someone having a diarrhea episode is disgusting and uncomfortable for both parties. But where's the evidence that a sign would prevent this from happening and what illnesses it would prevent from spreading? If anything, the diarrhea signs undermine the credibility of other signs that broadcast legitimate pool rules, such as 'no diving.' And while they probably won't keep people with diarrhea away, they do attract delinquents."

Prop. 13 Loophole from page 1

AB 2372 purports to close this "loophole" by changing the law to define a "change in ownership" as the sale or transfer of 90% or more of the ownership interests in a corporation, partnership or limited liability company in a 36 month period.

As can be seen, the bill does not abolish the "separate entity" treatment afforded to entities owning real property, but does clamp down on what the sponsors of the bill saw to be as one of the law's more "obvious and egregious loopholes." As such, there is still room for clever tax planning, such as transferring less than 90% of the ownership interests in an entity, or structuring a transfer of more than 90% of the ownership interests to occur over more than 36 months. AB 2372 also exempts the sale or transfer of stock or ownership interests in a publicly traded corporation or partnership, unless the stock or interests are acquired as a part of a merger or acquisition.

"Even with the "fix" to the Prop. 13 "loophole," there is still room for clever tax planning, such as transferring less than 90% of the ownership interests in an entity, or structuring a transfer of more than 90% of the ownership interests to occur over more than 36 months."

The bill, co-sponsored by left-wing Assemblyman Tom Ammiano, gained rare bipartisan support in the Assembly, and even obtained the support of (or more accurately the "non-opposition" from) the influential Howard Jarvis Taxpayers Association. AB 2372 now moves to the Senate.

TDS, from page 2

The issue on appeal was whether a seller of mixed-use property is required to provide a TDS. Under §1102 of the Civil Code, the seller is required to provide a TDS to the buyer in a sale or transfer of "real property . . . improved with or consisting of not less than one nor more than four dwelling units."

The seller argued that the Transfer Disclosure Law was never intended to apply to a transaction which was essentially commercial in nature between sophisticated parties. The seller urged the court to "consider the essence of the transaction" to determine whether it was residential in nature or commercial in nature in determining whether a TDS was required.

Surprisingly, the court declined to do so, holding that the statutory language was "clear and unambiguous" and "applies to any transfer of real property on which are located one to four residential units, regardless of whether the property also has a commercial use." The court also held that the TDS requirement could not be waived and was not waived by an "as-is" clause in the AIR form contract.

Undoubtedly, the decision in *Richman* was a windfall for the buyer. Further, it seems doubtful the Legislature intended the TDS requirement to apply to commercial transactions between sophisticated investors involving mixed-use property. However, at the very least, the *Richman* decision offers clear "black and white" guidance to sellers of mixed-use property. Thus, while it creates a potential trap for the unwary, the decision avoids future litigation inviting the courts to determine whether a transaction was "primarily commercial" or "primary residential" in nature. It will be interesting to see whether the Legislature responds to the decision by amending the Transfer Disclosure Law.

Update on Lakes Water System Class Action

On January 23, 2014, the Green Valley Landowners Association (GVLA) filed a class action lawsuit against the City of Vallejo challenging, amongst other things, the exorbitant and discriminatory water rates its charges the non-resident customers of the Vallejo's "Lakes Water System."

The City of Vallejo filed a demurrer to the complaint, alleging that the complaint failed to state a cause of action. After several postponements, Judge Arvid Johnson issued a tentative ruling sustaining Vallejo's demurrer on June 10, 2014. On June 11, 2014, the Court heard oral arguments for over an hour. Following oral argument, Judge Johnson agreed to accept additional briefing from the GVLA and Vallejo. After considering the additional briefing, Judge Johnson will issue a final ruling.

While it is not known whether Judge Johnson will reverse his tentative ruling, one thing seems certain – regardless of Judge Johnson's ultimate ruling, the legal issues involved in the complaint will make their way to the California Court of Appeal. The Court of Appeal will conduct its own review of the legal issues involved and will render a decision. The GVLA remains confident it will prevail. To read the complaint or the briefs filed in connection with the demurrer, go to http://www.smflynn-law.com/documents.html.

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