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Code Sections Affected

Corporations Code § 17002 (amended); Revenue and Taxation Code §§ 17047 (new), 69.4, 214, 214.01, 214.02, 214.5, 214.8, 214.14, 17076, 19191, 19192, 19194 (amended).
AB 3073 (Committee on Revenue and Taxation); 2004 Stat. ch. 354.

I. INTRODUCTION

Rosa Garcia grieved as she watched toxic cleanup crews, on orders from the Environmental Protection Agency, demolish her home of thirty-four years in Westminster, California.[1] Ms. Garcia, a widow receiving a Social Security pension, not only had her home demolished, but also watched her property taxes soar three hundred percent after purchasing a replacement home.[2]

In 1998, California voters overwhelmingly passed Proposition 1,[3] which amended the California Constitution to allow owners of qualified contaminated properties (QCPs)[4], like Ms. Garcia, who lose their property because of environmental contamination, to avoid property tax increases when they rebuild or buy another property.[5] Specifically, Proposition 1 allowed the owners of QCPs to pay the same amount in property taxes on their replacement property as they were paying for their contaminated property, regardless of whether the replacement property would otherwise be subject to higher taxes.[6]

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1. Carl Ingram, *California Elections/Proposition: Tax Help for Victims of Dump Cleanups Sought: That and Two Other Technical Measures Approved by the Legislature are on Tuesday's Ballot*, L.A. TIMES, Oct. 30, 1998, at A34.

2. *Id.*

3. *See* CALIFORNIA SECRETARY OF STATE, STATEMENT OF VOTE: 1998 GENERAL ELECTION: NOVEMBER 3, 1998: SUMMARY OF THE STATEMENT OF VOTE 12 (1998), *available at* http://vote98.ss.ca.gov/Final/sov/summary.pdf (on file with the *McGeorge Law Review*) (stating that 71.06% California voters voted "Yes" on Proposition 1).

4. *See* CAL. CONST. art. XIII A § 2(i)(2)(A)-(D) (defining "qualified contaminated property" as: residential property that is rendered uninhabitable, and if nonresidential, is rendered unusable due to an environmental problem or problems; property that is located on a site that a state or federal government agency has designated as a toxic or environmental hazard or as an environmental cleanup site; property that has or had structures on it that were substantially damaged or destroyed as a result of the environmental cleanup activities; property where the lead state or federal agency has stipulated that the property was not rendered uninhabitable or unusable by an act or omission of the owner of the property and the owner did not know the property was contaminated at the time the property was acquired or constructed).

5. Ingram, *supra* note 1.

6. *Id.*; *see also* LEGISLATIVE DIVISION, STATE BD. OF EQUALIZATION, LEGISLATIVE BULLETIN:

Shortly after the voters approved Proposition 1, the legislature implemented the provisions contained therein by adding section 69.4 to the Revenue and Taxation Code.[7] However, section 69.4 lacked certain statutory language that counties needed to determine if a replacement property qualified for the base year value transfer.[8] Most importantly, section 69.4 did not protect property owners from losing the advantages of transferring the base year value of the QCP due to property value inflation during the five year period allowed to obtain a replacement property.[9] Chapter 354 seeks to remedy this lack of protection and improve the administration of section 69.4.[10]

Limited liability companies (LLCs)[11] offer a valuable tool to non-profits that desire to invest in real estate for their operations, while at the same time, protecting their directors and other assets from unlimited liability associated with a particular property.[12] California's Revenue and Taxation Code exempts property that is used exclusively for religious, hospital, scientific, or charitable purposes and is owned and operated by funds, foundations, or corporations (i.e. non-profits) meeting certain statutory requirements from property taxation under what is commonly referred to as a "welfare exemption."[13] However, prior to Chapter 354, non-profits that sought both limited liability through the LLC entity and the welfare exemption could not do so because the Revenue and Taxation Code did not specify LLCs as entities afforded the welfare exemption. Furthermore, the California Board of Equalization (BOE) did not interpret California law as allowing non-profits to form LLCs.[14]

Chapter 354 allows non-profits to both form LLCs and allows those LLCs to qualify for the welfare exemption.[15] The impetus behind this provision of Chapter

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PROPERTY TAXES LEGISLATION 25 (1998), *available at* http://www.boe.ca.gov/legdiv/ptleg/pdf/98pt bulletin.pdf (on file with the *McGeorge Law Review*) (discussing how under article XIII A of the California Constitution, a property is taxed at a certain percentage of its base year value, the base year value is defined as the initial value of a property when ownership is transferred or undergoes new construction)

7. Letter from Richard C. Johnson, Deputy Director, Property Taxes Department, State Board of Equalization, to County Assessors (Feb. 8, 2000), *available at* http://www.boe.ca.gov/proptaxes/pdf/lta0012.pdf (on file with the *McGeorge Law Review*).

8. STATE BOARD OF EQUALIZATION, STAFF LEGISLATIVE BILL ANALYSIS OF AB 3075, at 5 (May 5, 2004), *available at* http://www.boe.ca.gov/legdiv/ptleg/pdf/ab3075-1rk.pdf [hereinafter BOE ANALYSIS] (on file with the *McGeorge Law Review*).

9. BOE ANALYSIS, *supra* note 8, at 6.

10. *Id.*

11. *See* BLACK'S LAW DICTIONARY 117 (2nd pocket ed. 2001) (defining an LLC as "[a] company–statutorily authorized in certain states–that is characterized by limited liability, management by members or managers, and limitations on ownership transfer").

12. *See* FRANK A. GEVURTZ, CORPORATION LAW § 1.1.1(e) (2000) (discussing how owners of limited liability companies enjoy limited liability equivalent to that of corporation shareholders).

13. BOE ANALYSIS, *supra* note 8, at 1 (referring generally to California Revenue and Taxation Code section 214).

14. *Id.* at 3; E-mail from Rose Marie Kinnee, Legislative Analyst, Legislative Division, California Board of Equalization, to Christopher J. Conant, Author (June 1, 2004, 11:02:54 PST) (on file with the *McGeorge Law Review*);

15. *See* CAL. REV. & TAX. CODE § 214 (amended by Chapter 354) (requiring that the LLC must be

354 stems from numerous inquiries to the BOE from non-profits that could take advantage of the welfare exemption but sought to do so as LLCs.[16]

In addition to allowing LLCs to apply for the welfare exemption, the California legislature, in passing Chapter 354, extended another benefit to LLCs. Chapter 354 allows out-of-state LLCs doing business in California to report their past and current business activity in California to the Franchise Tax Board (FTB) without fear of incurring the substantial penalties that are associated with delinquent filings of returns and tax payments.[17]

Chapter 354 also brings California income tax law into conformity with federal income tax practice with regard to individuals who repay an amount of income received in the prior year.[18]

II. EXISTING LAW

A. *Qualified Contaminated Properties*

Under current law, counties are unable to determine whether a replacement property for a QCP qualifies for a base year transfer because the statutory language lacks in certain elements.[19] Current statutory law establishes that the base year value of the QCP may transfer to a replacement property.[20] However, the statutory law does not further define what constitutes a replacement property.[21] This absence left county assessors to rely on the Constitutional provision under which section 69.4 of the Revenue and Taxation Code is implemented.[22] The Constitutional provision establishes that the replacement property for the QCP must be "equal to or less than" the fair market value of the QCP had the QCP not been contaminated.[23] Relying on this language, county assessors will not allow a base year value transfer to a replacement property if the

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organized and operated for religious, hospital, scientific or charitable purposes; that is, a non-profit may not form an LLC to be used for purposes other than those enumerated above and still receive the welfare exemption.

16. BOE ANALYSIS, *supra* note 8, at 3; *see also*, Letter to [Redacted] from Susan Scott, Tax Counsel, California Board of Equalization, Jan. 12, 2000 [hereinafter Letter from Susan Scott of Jan. 12, 2000] (on file with the *McGeorge Law Review*); Letter to [Redacted] from Susan Scott, Tax Counsel, California Board of Equalization, March 1, 1999 (on file with the *McGeorge Law Review*). Both letters respond to inquiries from organizations as to whether the BOE will allow an LLC formed and operated by a non-profit to qualify for the welfare exemption.

17. FRANCHISE TAX BOARD, SUMMARY ANALYSIS OF AB 3073, at 2 (July 19, 2004), *at* http://www.ftb.ca.gov/law/legis/03_04bills/AB3073_071204.pdf (on file with the *McGeorge Law Review*).

18. SENATE FLOOR, COMMITTEE ANALYSIS OF AB 3073, at 2 (July 21, 2004).

19. BOE ANALYSIS, *supra* note 8, at 5.

20. CAL. REV. & TAX. CODE § 69.4(a)(1) (West 2004).

21. *Id.*

22. E-mail from Rose Marie Kinnee, Legislative Analyst, Legislative Division, California Board of Equalization, to Christopher J. Conant, Author (June 9, 2004, 11:02:54 PST) [hereinafter Kinnee e-mail of June 9, 2004] (on file with the *McGeorge Law Review*).

23. CAL. CONST. art. XIII A § 2(A)(i).

fair market value of the replacement property is greater than the fair market value of the QCP if the QCP were not contaminated.[24]

Because current law allows only the replacement property to be purchased or newly constructed within five years of selling the QCP, the "equal to or less than" language as applied by county assessors prevents affected property owners from being able to transfer the base year value to a comparable property due to California's upwardly volatile real estate market.[25]

B. Limited Liability Companies

1. The Welfare Exemption

Current law provides for a welfare exemption under which property is exempt from property taxes if it is used exclusively for certain purposes and is owned and operated by community chests, funds, foundations or corporations organized for such purposes.[26] The California Constitution permits the legislature to exempt certain property from taxation.[27] Specifically, the Constitution allows a welfare exemption for property that is used for religious, hospital, or charitable purposes and owned or held in trust by corporations or other entities. However, the legislature has limited the term "other entities" to include only community chests, funds or foundations but does not clearly permit an LLC to qualify for the welfare exemption.[28] Thus, even though the Constitution allows for LLCs to qualify for the welfare exemption under the "other entities" language, because the legislature has not explicitly provided for LLCs in Revenue and Taxation Code section 69.4, the BOE consequently has not permitted LLCs to qualify for the welfare exemption.[29]

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24. *See* Kinnee e-mail of June 9, 2004, *supra* note 20 (explaining that under current law, if the QCP fair market value was $500,000 but the value of the replacement property was $500,001, the replacement property would not qualify for a base year transfer).

25. *See* BOE ANALYSIS, *supra* note 8, at 5 (May 5, 2004) (explaining that Chapter 354 would afford some protection to affected property owners from inflation because current statutory law does not allow the term "equal or less than" to account for inflation).

26. CAL. REV. & TAX. CODE § 214 (West 2004).

27. CAL. CONST. art. XIII § 4(b).

28. ASSEMBLY COMMITTEE ON REVENUE & TAXATION, COMMITTEE ANALYSIS OF AB 3075, at 4 (May 3, 2004).

29. *See* Letter from Susan Scott of Jan. 12, 2000, *supra* note 16 (explaining that the BOE cannot read section 69.4 beyond the plain meaning of the statutory language to allow an LLC to qualify for the welfare exemption, also explaining that the BOE appreciates the position of non-profits that seek to take advantage of forming an LLC but cannot do so without losing their exempt status).

2. *Voluntary Disclosure Agreement*

Current law allows out of state corporations to voluntarily to disclose their business activities in California to the FTB to determine if they exhibit a sufficient presence in California to require payment of California tax.[30] In return for their voluntary disclosure, the FTB waives, for the preceding six years, all claims of penalties that it could otherwise impose on those corporations for noncompliance with the California tax code.[31] However, current law does not extend this waiver to LLCs.[32]

C. *The "Claim of Right Doctrine"*

Under federal income tax practice, a taxpayer may assert a "claim of right" where that taxpayer "repays an amount of income received in a prior year to claim either a deduction for that income or a credit equal to the amount of tax paid, whichever is greater."[33] Prior California law did not conform to this practice and instead only allowed a taxpayer who repaid the previous year's income to claim an itemized "miscellaneous deduction" for the prior year.[34] However, the "miscellaneous deduction" is limited to the amount by which the deduction exceeds two percent of the taxpayer's income.[35] Thus, under prior California law, a taxpayer who repaid income from the prior year would be significantly limited in the amount of deduction he or she could claim for that repayment whereas federal income tax law would allow that taxpayer to recover on the full amount of income repaid.

III. CHAPTER 354

A. *Qualified Contaminated Properties*

Chapter 354 changes the current California Revenue and Taxation Code concerning property taxation of QCPs in three significant ways. First, Chapter 354 establishes that an owner of a QCP may take advantage of property tax relief by transferring the base year value of the QCP to a replacement property only if the replacement property is a comparable property.[36] Chapter 354 then defines comparable replacement property (CRP) as "property that is similar in utility and

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30. ASSEMBLY COMMITTEE ON APPROPRIATIONS, FISCAL SUMMARY OF AB 3073, at 1 (July 19, 2004).
31. *Id.*
32. CAL. REV. & TAX CODE § 19192 (West 2004).
33. ASSEMBLY COMMITTEE ON APPROPRIATIONS, FISCAL SUMMARY OF AB 3073, at 1-2 (July 19, 2004).
34. SENATE FLOOR, COMMITTEE ANALYSIS OF AB 3073, at 2 (July 21, 2004).
35. *Id.*
36. CAL. REV. & TAX. CODE § 69.4(a)(1) (amended by Chapter 354).

function to the property that it replaces. Property is similar in function and utility if it is, or is intended to be, used in the same manner as the qualified contaminated property."[37]

Second, Chapter 354 establishes that for the QCP's base year value to transfer to the comparable replacement property, the CRP must be of equal or lesser value to the QCP.[38] The CRP is a property of "equal or lesser value" to the QCP if the CRP is purchased or newly constructed within the first year following the sale of the QCP and does not exceed 105% of the full cash value of the QCP.[39] The "equal or lesser value" percentages increase to 110%, 115%, 120% and 125% of the full cash value of the QCP for the second, third, fourth, and fifth, respectively, for the years following the sale of the QCP.[40]

Third, Chapter 354 establishes that the CRP be located in the same county as the QCP.[41] However, Chapter 354 allows a county board of supervisors to adopt a resolution permitting the base year value of a QCP purchased in another county within California to transfer to a CRP purchased within the county over which that board of supervisors presides.[42]

B. Limited Liability Companies

1. The Welfare Exemption

Chapter 354 also changes the Current California Revenue and Taxation Code with respect to entities entitled to the property tax welfare exemption under article XIII section 4(b) of the California Constitution.[43] Chapter 354 provides that LLC's are "other entities" within the meaning of the California Constitution with respect to certain provisions of the Revenue and Taxation Code.[44] Specifically, under Chapter 354, "an LLC that is wholly owned by a qualifying non-profit organization organized and operated exclusively for religious, hospital, scientific or charitable purposes and recognized as a non-profit organization under federal and state income tax law may qualify for the welfare

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37. *Id.* § 69.4(e)(7).

38. *Id.* § 69.4(a)(1).

39. *Id.* § 69.4(e)(2)(A); *see also id.* § 69.4(e)(5) (establishing that the full cash value of the QCP is the fair market value of the QCP as if it were not contaminated pursuant to article XIII A section 2(i)(1)(A) of the California Constitution).

40. *Id.* § 69.4(e)(2)(B)-(E); *see id.* § 69.4(b) (stating that the base year value of the QCP will only transfer to the CRP if the CRP is purchased or newly constructed within five years after the sale of the QCP).

41. *Id.* § 69.4(a).

42. *Id.* § 69.4(a)(2) (stating further that if the county board of supervisors adopts such a resolution, the remaining provision of section 69.4 are still applicable).

43. BOE ANALYSIS, *supra* note 8, at 1; *see* CAL. CONST. art. XIII § 4(b) (dictating that "[p]roperty used exclusively for religious, hospital, or charitable purposes and owned or held in trust by corporations or *other entities*" may be exempt from property taxation (alteration in original) (emphasis added)).

44. BOE ANALYSIS, *supra* note 8, at 1.

exemption."[45] In support of the above mentioned amendments regarding LLCs, Chapter 354 also provides that an LLC may "engage in lawful business activity, whether or not for profit" with certain limited exceptions.[46]

2. *Voluntary Disclosure Agreement*

By including LLCs in the definition of "qualified entit[ies]" in California Revenue and Taxation Code section 19192, Chapter 354 allows LLCs to enter into voluntary disclosure agreements with the FTB.[47] By allowing LLCs to qualify as entities that may enter into voluntary disclosure agreements with the FTB, Chapter 354 extends the protections afforded other entities who disclose their business activities in California to the FTB.[48]

C. The Claim of Right

Chapter 354 adds section 17049 to the Revenue and Taxation Code and allows a taxpayer who repays an amount of income received in the prior year or years to claim either an unrestricted deduction or a refundable credit for tax paid in the prior year or years on the repaid income.[49] Furthermore, Chapter 354 removes from the miscellaneous itemized deduction of the Internal Revenue Code any deduction made as part of a claim of right, or in other words, any income from a previous year that was repaid and is being claimed as a deduction from that year's income.[50]

IV. ANALYSIS

The effect of Chapter 354 as it applies to transferring the base year values of QCPs will be limited because very few properties actually qualify for the transfer.[51] In fact, Chapter 354 will result only in an estimated loss of $100,000

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45. *Id.* at 6. *See* CAL. REV. & TAX. CODE §§ 214(a)-(d), (g), (h), (i), 214.02, 214.14 (amended by Chapter 354) (establishing that property operated by an LLC for religious, hospital, scientific or charitable purposes may also be exempt from property taxation when the property is used exclusively for: school purposes of less than collegiate grade; nursery school purposes; educational FM broadcast or television stations; rental housing; emergency or temporary shelter for homeless persons and families; housing for employees of the religious, charitable, scientific or hospital organization; environmental or geological preservation; charitable purposes of museums).

46. CAL. CORP. CODE § 17002 (amended by Chapter 354); *see id.* § 17002 (West 2004) (stating only that an LLC "may engage in any lawful business activity" without further providing that such activity may or may not be for profit).

47. CAL. REV. & TAX CODE § 19191 (amended by Chapter 354); *see supra* text accompanying note 17.

48. ASSEMBLY COMMITTEE ON APPROPRIATIONS, FISCAL SUMMARY OF AB 3073, at 1 (July 19, 2004); *see supra* accompanying notes 30-32.

49. CAL. REV. & TAX CODE § 17049 (enacted by Chapter 354).

50. *Id.* § 17076.

51. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF AB 3075, at 2 (May 1, 2004).

annually.[52] And while Chapter 354 attempts to protect QCP owners from property inflation by providing a 5% per year inflation adjustment for a replacement property, it is unlikely that an affected property owner would actually benefit from Chapter 354 because property values in California are subject to extreme annual value increases. In fact, median residential property values in 2002 and 2003 increased 21.4% and 17.9% respectively.[53] Thus, it appears that Chapter 354 only provides added protection to affected property owners in two situations: (1) the owner purchases the replacement property within the permitted time and during a relatively stable market; and (2) the owner sells the QCP in a rising market but quickly purchases a replacement property before its value increases to more than 5% of the value of the QCP.[54]

The LLC provision of Chapter 354 is likely to be utilized more than the QCP provision simply because non-profit organizations far outnumber owners of QCPs.[55] However, this does not necessarily mean that the LLC provision will result in significant revenue loss.[56] The reason for this is because under Chapter 354 a qualifying non-profit organization that currently enjoys the welfare exemption need only change the method by which it holds title to the exempt property.[57] Instead of holding title as a community chest, fund, foundation, or corporation, the non-profit may now hold title as an LLC.[58]

In addition, this provision of Chapter 354 is likely to be widely utilized by the many non-profit organizations interested in taking advantage of the liability benefits of being an LLC.[59] Indeed, Chapter 354 is a direct response by the BOE to numerous inquiries and petitions to extend the welfare exemption to LLCs.[60]

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52. *Id.*

53. Robert Kleinhenz, Ph.D., Cal. Ass'n of Realtors, *2003 Finishes on High Note, at* http://www.car.org/index.php?id=MzMzNzI (Feb. 2004) (on file the *McGeorge Law Review*); Robert Kleinhenz, Ph.D., Cal. Ass'n of Realtors, *A Final Look at 2002, at* http://www.car.org/index.php?id=MzE3NjU (Feb. 2003) (on file with the *McGeorge Law Review*).

54. The value of the QCP is determined to be its value as if it were not contaminated. CAL. REV. & TAX. CODE § 69.4(e)(5) (amended by Chapter 354).

55. *Compare* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF AB 3075, at 2 (May 12, 2004) (explaining that very few properties qualify for the base year value transfer under the QCP provisions), *with* BOE ANALYSIS, *supra* note 8, at 3 (explaining that many non-profit organizations have approached the BOE investigating the possibility of reforming as an LLC).

56. *See* BOE ANALYSIS, *supra* note 8, at 7 (estimating a revenue loss of not more than $100,000 annually).

57. BOE ANALYSIS, *supra* note 8, at 6-7.

58. CAL. REV. & TAX. CODE § 214(a) (amended by Chapter 354).

59. BOE ANALYSIS, *supra* note 8, at 3; *see also* Letter from Susan Scott of Jan. 12, 2000, *supra* note 16 (describing that a non-profit may seek to engage in real estate development while at the same time protecting its assets through formation as an LLC).

60. BOE ANALYSIS, *supra* note 8, at 3-4.

V. CONCLUSION

The California legislature is known for enacting contentious and partisan legislation; however, Chapter 354 is not one of those examples. Indeed, Chapter 354 found little to no opposition throughout its legislative history.[61] Of course, it seems that most Californians would not want to pour salt on the wounds of an innocent owner of a contaminated property by not extending to them some measure of property tax protection. Really, the only question left open by Chapter 354 is whether it affords the innocent property owner enough protection from real estate inflation.

As discussed earlier, the QCP provision of Chapter 354 is not likely to be utilized frequently. On the other hand, the LLC provision may prove more significant as qualified non-profits seek to take advantage of both the welfare exemption and the protections afforded by organization as an LLC.

61. *See* ASSEMBLY FLOOR, ASSEMBLY VOTE ON AB 3075 (May 20, 2004) (listing seventy-seven ayes and zero noes for the Assembly vote on AB 3075); ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF AB 3075, at 4 (May 12, 2004) (listing no organized opposition to AB 3075).