The "Unpreservation" of the Base Year Value Transfer Under Threat of Eminent Domain

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Californians who have owned their properties for years understand the benefits of Proposition 13: their property taxes are based upon the property's purchase price (with only small allowable annual increases), as opposed to the property's current value. But upon a transfer, the property gets reassessed at its current value. Consequently, people in California often wind up with higher property taxes when they sell one property and buy another, even if the new property costs exactly what they received for the sale of the old property.

When an owner is forced to "sell" as a result of the government's power of eminent domain, this rule does not apply. Rather, California law contains an exception which allows condemned owners to keep their Proposition 13 base year value and transfer it to a replacement property. This same exception applies whether the government actually condemns the property or simply purchases the property under the threat of eminent domain.

However, based on a recently published Court of Appeal decision, *Duea v. County of San Diego*, a loophole may prevent owners from receiving the benefits of the base year value transfer if they sell their property under threat of eminent domain to anyone other than a public entity. While the statute does not define "public entity," the phrase is typically used to describe the state, subdivisions of the state, and other public agencies; the definition does not encompass private companies.

This means that, for example, an owner facing condemnation by a utility company could not sell the property to the company until the actual eminent domain action has been filed, or the owner will lose the base year value transfer. This is because utility companies are usually private companies which do not qualify as "public entities," despite (1) their often being referred to as "public" utilities, and (2) their possessing the power of eminent domain, a power most people associate -- incorrectly -- only with governmental entities.

This loophole – if it really exists – creates exactly the wrong incentive, forcing owners to demand that a non-public entity file a condemnation action even if the owner believes the offer is fair. It also appears to conflict with a parallel provision under income tax law, which does not differentiate between public agencies and other buyers where a sale occurs under threat of eminent domain.

Proposition 13 Background

Proposition 13 – enacted in 1978 – provides that real property taxes shall be based on a property's acquisition price (the "base year value"), and such amount cannot be increased more than two percent per year. It essentially changed California's real property tax system from one based on the current market value of property to one based on the acquisition value of property, plus an allowable increase over time. And with historical increases in California's property values, long-time owners have seen their actual value and their assessed value vary dramatically; some owners are paying taxes based on values that represent only a fraction of the property's current market value.

Upon a change in ownership, the property is reassessed at a new base year value (i.e., revalued at the current value), meaning the buyer will pay taxes at a new base value. Similarly, an owner who buys another property, even at the same price as the property sold, may face dramatically higher property taxes.

An exception exists that allows a property owner to carry over the base year value to a comparable replacement property where the owner is displaced as a result of eminent domain, or under threat of eminent domain by a public entity.

The *Duea* Decision

In *Duea*, a property owner faced the prospect of eminent domain as part of the construction of the San Diego Padres stadium. After watching neighboring properties become the subject of condemnation actions by the redevelopment agency, the owner eventually sold his property directly to the private developer working with the redevelopment agency. When the owner sought to transfer his base year value to a replacement property, his request was denied because he sold the property to a private developer – not a public entity.

The owner appealed, claiming he had been displaced as a result of eminent domain or its functional equivalent. The redevelopment agency even confirmed that the transfer was for use in connection with the new ballpark and that **the property would have been condemned if the owner refused to sell.** The Assessment Appeals Board denied the owner's claim, finding that a transfer under threat of eminent domain to a private entity does not fall within the exception that allows for a transfer of the base year value.

The owner then filed a lawsuit in the superior court, and for the first time argued that the private developer acquired the property as an agent for the redevelopment agency, and therefore the sale qualified as a sale to a public entity under threat of eminent domain. The trial court concluded that the owner could not present this "agent theory" in the trial court, as issues that are not raised during the administrative process cannot be raised for the first time in the trial court. Nevertheless, the trial court went on to state that the owner failed to demonstrate that the private developer was an agent of the redevelopment agency.

On appeal, the court agreed that the owner faced a procedural hurdle as a result of switching arguments for why the base year value transfer was applicable. The court also concluded that the judicial system could not consider a new factual dispute as to whether the private developer was the agent of the redevelopment

agency because this issue was not raised during the administrative process.

Thus, while the *Duea* court's actual holding was largely procedural, the clear implication from the decision is that if a property owner faces condemnation by a non-public entity, the owner loses the ability to transfer the Proposition 13 base year value to a replacement property if the owner sells before the condemnation action is filed. And based on the plain language of the statute, this likely is the correct analysis. The law provides that a property owner can receive the benefits of the base year value transfer if the owner is displaced (1) as a result of an eminent domain action or (2) under threat of eminent domain by a *public entity*.

Duea **and Income Taxes**

Duea involved how a sale is treated for property tax purposes, but property transfers can also trigger income tax implications. In particular, where an owner sells property for more than its purchase price, the resulting gain is typically taxed. But much like the exception described above, the income tax laws provide an exception for property transfers occurring through eminent domain or under threat of eminent domain.

Where that occurs, the owner can acquire replacement property through a "1033 exchange," and as long as the proceeds of the "sale" get invested in the replacement property, the gain that would otherwise get taxed is deferred.

But what about the situation in *Duea*, where the sale under threat of eminent domain is not to a public agency? Fortunately, the property tax quirk that excludes from the exemption sales to anyone other than a public agency does not exist in the income tax laws. As a result, any sale made under threat of eminent domain could qualify for a deferral of gain as part of a proper "1033 exchange."

The decision provides a good reminder that one cannot simply look at one set of regulations (either the income tax laws or the property tax laws) and assume that a strategy that successfully avoids or defers tax under that set of regulations will also avoid or defer tax under the other set of regulations. Both the income tax rules and the property tax rules are hyper technical – and they are not always in accord with one another. Anyone concerned about tax issues should be sure to consult – and comply with – both sets of rules to avoid a nasty tax surprise.

A Legislative Fix?

The *Duea* case begs the question of whether a legislative fix is necessary with respect to the Proposition 13 transfer exception. Why must the sale be under threat of eminent domain by a *public entity*? If an owner can demonstrate he or she was displaced as a result of an eminent domain action or under threat of eminent domain, that should be sufficient. If the transfer is directly to a public or private utility company, the owner should reap the same benefits of the base year value transfer in these circumstances.

Nobody benefits from the current rule. The acquiring entity faces unnecessary condemnation actions even when offering a fair price for property. The property owner faces a similar problem: either litigate or face a potential tax consequence. The only "beneficiary" of this quirk would be the government, which would presumably receive additional tax revenue any time one of these situations forces an owner to pay more in property taxes. But even this can only occur where the owner (or its attorney) makes the mistake of allowing a sale to occur before a condemnation action is filed. And with the *Duea* opinion on the books, this can happen only if someone does not understand the law.

The bottom line is that no reason exists that California's property tax rule should not be in accord with the parallel income tax provision. The rule that trapped Duea serves no legitimate purpose, and will only force unnecessary litigation just to avoid unfavorable tax treatment. But until such time as the law is fixed, owners must take care not to find themselves in the same position as the seller in *Duea*, and non-public entities with the power to condemn should understand this quirk in the law when trying to negotiate deals under threat of eminent domain.