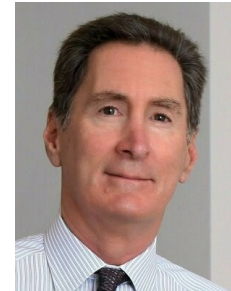


LA's High-Value Real Estate Transfer Tax Should Be Scrapped

By **Paul Weinberg** (June 28, 2023)

When does a tax become confiscatory? At what point does a tax, however well-intentioned, impose such a heavy burden that the very ill that it is trying to address is exacerbated by the tax itself?

This is exactly the series of questions that lawmakers, special interest groups, and government agencies are now asking themselves in light of the **passage** of Initiative Ordinance ULA, adopted by the voters of Los Angeles, California, which radically increased the percentage of real property tax collected on the sale of any real property, commercial or residential, in the city of Los Angeles, where the purchase price exceeds \$5 million.



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Passage of the ordinance spawned at least two separate lawsuits challenging it; they were filed as preemptive strikes, before the law went into effect. The new law went into effect in Santa Monica, California, on March 1, and in Los Angeles on April 1.

The lawsuits, Newcastle Courtyards LLC v. the City of Los Angeles in the U.S. District Court for the Central District of California, and Howard Jarvis Taxpayers Association v. the City of Los Angeles in the Superior Court of the State of California for the County of Los Angeles, were consolidated on April 28.

The lawsuits themselves have not produced much resolution. No substantive court hearings have taken place, and the courts elected not to issue injunctions but to wait until discovery is done to see if the law is void on its face. That may not happen for another six months to a year because California courts are only now getting back on track after COVID-19 closures.

The text of the measure talks about why the ordinance is being enacted in the first place — it's to provide housing affordability, and to alleviate homelessness and all the ills the current situation brings with it. In its purpose language it mentions the serious increase in the cost of existing housing, and the rapidly worsening social effects of homelessness, including crime, public health issues, and related ills.

Not surprisingly, people who don't have money would like to require wealthy people to give money to provide housing assistance that would make their lives easier. Those people vote — they did on Nov. 8, 2022.

What is the fallout from and aftereffects of passing this initiative? How will it affect real estate development and the ability to sell real property in Los Angeles on an ongoing basis?

To answer the first question, the best place to start is with the initiative process itself. Initiatives are placed on the ballot by voters, not government officials, political appointees or the elected.

Los Angeles' election code provides that five proponents have to:

- Sign a letter designating themselves as representatives;
- Include the full text of the ordinance itself;

- Draft a petition; and
- Get signatures of 15% of the total votes cast for all candidates for office of mayor in the last election.[1]

In Los Angeles' case, 512,808 people, or 57.77%, voted for the initiative, and 374,934 people, or 42.23%, voted against it.

A slew of special interest groups supported it too, including the American Civil Liberties Union, the Center for Biological Diversity, the Housing Rights Center and Homelessness Now Los Angeles, as well as a number of powerful local unions — Service Employees International Union Local 2015, SEIU Local 721, American Federation of State, County and Municipal Employees District Council 36 and International Brotherhood of Electrical Workers Local 11.

There's a pattern here. Most likely, few of the people who supported this petition were in a position to suffer any ill effects from it financially.

To understand those effects, it's necessary to understand the specifics the initiative mandates. Where the sale of real property with a purchase price of \$5 million or greater takes place, the real property transfer tax jumps from 0.56% to 4%. If the purchase price is \$10 million or more, it increases tenfold — from 0.56% to 5.5%.

These are not trivial numbers: On a \$20 million purchase, the tax due under the new initiative would be \$1.1 million.

Before examining on a macro level the effect of a tax of this nature, it's necessary to point out several underlying facts. First, properties that have a value of \$10 million or more can be and oftentimes are owned by small partnerships composed of individuals who pooled their savings or capital for a long-term real estate investment.

Many of these owners are older, having made the investment in the significant past and now are of an age or in a position in which they wish to cash out of the investment and use their capital for living expenses or long-term care. A tax of this magnitude significantly affects the net return these owners will receive after sale.

The tax was estimated to generate \$600 million to \$1.1 billion annually, but that number was based on the estimated number and value of existing sales. Now experience is showing that those estimates were wildly optimistic, and based on the number and value of sales remaining what they were before the new tax.

Not surprisingly, the initiative was opposed by the people and groups that would be most deeply affected by it: apartment owners' associations, building and construction industry

trade groups and Los Angeles' main taxpayer rights group, the Howard Jarvis Taxpayers Association.

The reason the Howard Jarvis Taxpayers Association's opposition was so important is that when the initiative passed, it filed the first lawsuit to stop it. That lawsuit argued that special real property transfer taxes — those dedicated to a specific purpose — are prohibited by Article XIII A, Section 4 of the California Constitution.

The Howard Jarvis Taxpayers Association's lead attorney, Laura Dougherty, told me that the potentially unexpected effects of this law are implicated in the 2017 holding of the California Supreme Court in *California Cannabis Coalition v. City of Upland*.

That case concluded that an initiative is not subject to some of California's state-law limits on taxes proposed by city councils and county boards of supervisors. Its broad language opened the door to the possibility that a special tax proposed by initiative could be immune from the requirement for two-thirds voter approval.

Dougherty made clear that the Upland holding's grant of broader latitude did not give initiative proponents a green light to override constitutional considerations simply because the initiative process was used to avoid having to seek specific legislation.

She also made the point that the proponents of Measure ULA are using the Upland decision to expand the initiative process to indicate that a tax passed by initiative doesn't have to comply with the California Constitution because it is not a legislative action.

So now the stage is set: According to the plaintiffs, the proponents of Measure ULA have, in essence, done an end run around both constitutional law and case law requirements that no special tax can be imposed because Proposition 13 and the later amendment to the California Constitution in Article XIII A, Section 4, prohibit it.

The Upland case provides some rationale for the position that, since the imposition of a tax wasn't a legislative act but took place via initiative, the constitution and, by reference, Proposition 13, don't apply. In essence, the tax has been imposed by the electorate, not by the city.

It's easy enough to see the harm and the chaos that would occur if this position prevailed, and the Upland case was extended to allow any initiative to impose a new tax of any amount, irrespective of whether it flies in the face of Proposition 13 and its constitutional amendment.

More importantly, though, the current tax is wreaking havoc on both the commercial and residential markets in Los Angeles. Sean Fulp of Collier's Real Estate in Los Angeles, clearly described the problem when he spoke at Connect CRE, a trade organization conference held in Los Angeles in April:

Unfortunately, Measure ULA significantly impacts property values. Most real estate capital stacks comprise approximately two-thirds debt and one-third equity. The additional 5.5% transfer tax comes directly from the equity, which could be 16.5% of an investor's proceeds after they repay the loan. In many cases, this represents most of the gains. Therefore, we expect development and value-add investment opportunities to be most impacted. We also anticipate that all transaction activity will decline, at least until property values account for the additional cost.[2]

Both the Los Angeles Times and other publications are tracking the significant detrimental effects that are being felt in the Los Angeles luxury real estate market due to Measure ULA and its tax structure. A May 5 Los Angeles Times article titled "LA's Luxury Real Estate Market Freezes, Putting 'Mansion Tax' funds in Limbo," cites some very relevant statistics: In March, when the luxury market reached the peak of its frenzy, there were 126 home and condo sales above \$5 million dollars in the City of L.A., according to the Multiple Listing Service. In April, once Measure ULA took effect, there were two. One sold in Brentwood for \$5.7 million, and the other traded hands in Venice for \$7.5 million. Together, they raised \$528,000 for the city to use for affordable housing and homelessness prevention programs. So far, that's it.[3]

Extraordinary steps were taken by brokers and owners to beat the ULA tax. A May 11 Real Deal article quoting a well-known residential broker in Los Angeles, Stephen Shapiro, described the current situation:

In March there was a scramble to sell luxury homes before the deadline for the ULA tax, which started April 1. In a market without the tax, a number of March deals would have closed in April, or even May. 'We had deals with seven- to 10-day escrows to beat ULA. There would not have been seven- to 10-day day escrows if there was no ULA', Shapiro said.[4]

Lawyers are also getting into the act to try to find ways around the ULA tax. These include splitting the ownership interest in a property, and selling only interests in the entity that owns the asset rather than selling the entire property interest to one buyer. Tenancy-in-common agreements are another method, as are seller carryback financing at a very high interest rate, sale of improvements and various estate planning vehicles.[5]

Given that the ULA tax has already had a significant chilling effect on transactions in Los Angeles, it is netting paltry income, and was not approved by the normal two-thirds majority that the state constitution mandates, is this a flawed piece of legislation that should be invalidated?

This author thinks so. The manner of the legislation's implementation and its subsequent effects prove the law of unintended consequences; that is, the actions of people — and especially of government — always have effects that are unanticipated or unintended.

In an economy already negatively affected by the ongoing debt-ceiling negotiations, the war in Ukraine and rampant inflation with rising interest rates, legislation of this type, while utopian, makes little sense. Timing in life is everything; this legislation suffers from bad timing and should be reevaluated.

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[1] See Election Code Sections 705, 712 and 718; see also City of Los Angeles Initiative, Referendum & Recall Petition Handbook, pages 2 and 6.

[2] Interview with Sean Fulp of Colliers of April 14, 2023, Page 2, Paragraph 3.
– <https://www.connectcre.com/stories/measure-ula-and-la-cre-qa-with-colliers-sean-fulp/>.

[3] Los Angeles Times, May 5, 2023, "L.A.'s luxury real estate market freezes, putting 'mansion tax' funds in limbo" by Jack Flemming, at Pages 2 and 3.

[4] "Luxury Home Sales in LA plummet after ULA tax start date" – The Real Deal, May 11 at 12:30 pm, quoting Stephen Shapiro, co-founder of Independent West Side Estate Agency
– <https://therealdeal.com/la/2023/05/08/luxury-home-sales-in-la-plummet-after-ula-tax-start-date/#>.

[5] See, e.g., Ervin Cohen & Jessup, Insights and Successes – "Nine Ideas to Avoid the Effect of Measure ULA – The New Mansion Tax" – published April 13, 2023, in The Real Dirt, <https://www.ecjlaw.com/publication-525>.