NOTE: Unless otherwise indicated, all statutory references in this chapter are to the California Revenue and Taxation Code.

Questions concerning taxes and assessments are raised in most real estate transactions. Taxation is an indirect yet significant controlling device affecting estimates of value. It is important for those engaged in the real estate business to know the variety of taxes and their effect on property transfers. Discussion of the specific taxes mentioned in this chapter is for reference purposes only and should not be relied upon as a substitute for professional advice. Full consideration may involve retaining the services of accounting, legal and tax specialists. There are many categories of property that may be exempt from taxation. The county assessor should be consulted for a determination in this area.

Federal, state and local governments tax real property. Local governments assess taxes directly on the property, such as ad valorem property taxes, special assessments and transfer taxes. Most state governments have an income tax. The federal and state governments tax property indirectly through the taxation of ordinary and capital gain on income earned from real estate. Federal and state governments also tax property indirectly when it is transferred through an estate or gift to others, i.e., estate and gift taxes.

Taxes may act as a deterrent to many individuals desiring to acquire or dispose of real property. Unless tax benefits and burdens and tax planning alternatives are seriously considered by persons contemplating the purchase or sale of real estate, the anticipated benefits of ownership may not be realized, and losses may be sustained.

PROPERTY TAXES

Property taxes are levied according to the value (ad valorem) of the property as of the date acquired, or the date of completion of any new construction. Generally, the more valuable the property and/or the more current its acquisition or construction date, the higher the tax. Property taxes, including Property Tax in-lieu of Motor Vehicle License Fees, represent a major source of income for counties in California. Approximately half of California’s one hundred million acres are owned by governments and therefore exempt from property taxation. All property within the jurisdiction of a taxing authority is taxable unless specifically exempt.

California’s Property Taxes

In June of 1978, California voters approved Proposition 13, amending the State Constitution so that the maximum annual tax on real property is limited to one percent of “full cash value” (market value) plus a maximum of two percent annual inflation factor based on the Consumer Price Index (CPI), as calculated by the California Department of Industrial Relations. (Sections 51 and 110.1) An additional sum is allowed to pay for indebtedness on affected property approved by voters prior to the passage of Proposition 13. Also, selected new indebtedness is allowed, only by a two-thirds vote of the residents affected. The passage of Proposition 39 in 2000, authorizes bonds for repair, construction or replacement of school facilities, classrooms, if approved by 55% local vote for projects evaluated by schools, community college districts, county education offices for safety, class size, and information technology needs.

Property Tax Liens

Property taxes become liens against real property on January 1 of the year preceding the fiscal year (July 1 - June 30) for which the taxes are levied. One-half the taxes on real property are due on November 1 and payable without penalty until 5 p.m. (or close of business, whichever is later) on December 10. The second half is due on February 1 and is delinquent if not paid by 5 p.m. (or close of business, whichever is later) on April 10. If either December 10 or April 10 falls on a Saturday, Sunday, or legal holiday, the time of delinquency is extended until 5 p.m. (or close of business, whichever is later) on the next business day. A ten percent penalty applies to an installment that becomes delinquent. If the second installment is delinquent, the tax collector adds a charge to place the property on the delinquent roll.

The Morgan Property Taxpayers’ Bill of Rights

The Morgan Property Taxpayers’ Bill of Rights (Section 5900, et seq.) and the related amendment to subdivision (e) of Section 408 require that the assessor allow, upon request of an assesse (or his/her designated representative), inspection and copying of documents, including an auditor’s work papers, relating to the
appraisal and assessment of assessees property. Further information concerning taxpayers’ rights relating to the assessment, audit, and collection of property taxes in this state may be obtained from the State Board of Equalization, Taxpayers’ Rights Advocate’s Office, P.O. Box 942879, Sacramento, CA 94279-0070. Telephone: (800) 400-7115, www.boe.ca.gov.

Establishing Values
Operating under constitutional provisions and statutes, assessors have established real property values as follows:

**No change in parcel since February 28, 1975.** If the parcel has not been further improved with structures and has not been sold or transferred since February 28, 1975, the assessor has established a base value for the parcel and then has applied an inflation rate to that base year value not to exceed 2% per year. Thus, the base year value is locked in place and cannot be changed unless there is a change in ownership or new construction.

**Parcel sold/changed ownership since February 28, 1975.** If a parcel has sold or otherwise changed ownership since February 28, 1975, its new base year value as of the date of change of ownership is enrolled for the following lien date and shall be adjusted upward by up to 2% each year.

**New construction.** If the improvement on the parcel was newly constructed since February 28, 1975 and the parcel remained in the same ownership prior to and after the construction, only the added “new construction” receives a new base year value. The land may have one base year for valuation purposes while the improvements constructed may have another. Only if the improvement is completed in the same assessment year that the parcel is purchased would the land and improvement have the same base year. “New construction” could also apply to land that has been significantly altered.

There are certain improvements which have been excluded from the definition of “new construction” for purposes of reappraisal:
1. water conservation equipment for agricultural use;
2. fire detection or extinguishing systems or modification for fire-related egress;
3. modification for access by disabled person; and
4. seismic retrofitting
5. normal maintenance and repair
6. construction or addition of any active solar energy system, as defined in subdivision (b) of Section 63 of the California Revenue & Taxation code
7. disabled person accessibility
8. environmentally contaminated property

**Parcel further improved since February 28, 1975 (or since constructed, sold or transferred).** If the parcel has been further improved (e.g., by an addition or swimming pool) since February 28, 1975 (or since constructed, sold or transferred), it has a 1975 base value year (or year of sale, construction or transfer) and an additional base year value on the new improvement.

Change in Ownership Exclusions. There are a number of exclusions from change in ownership and consequent reappraisal, some of which are described as follows:
1. Acquiring “comparable” replacement property for original property taken by a governmental agency in eminent domain actions, per Section 68.
2. Replacing property destroyed by disaster. Section 69 requires comparable replacement property to be acquired or newly constructed within 3 years of property substantially damaged or destroyed by governor-declared disaster. Section 69.3 permits counties to enact ordinances allowing such replacement property transfers from other counties. Section 70 requires that reconstructed property that is substantially equivalent to damaged property is not reassessed “new construction.”
3. Transferring the principal residence and first one million dollars of full cash value of real property between parents and their children pursuant to Section 63.1, provided that a claim for the exclusion is filed with the
assessor within 3 years of the date of transfer or within 6 months after the date of mailing of the notice of supplemental or escape assessment.

Subject to subparagraph (B) of Section 63.1, transfers occurring on or after March 27, 1996, between grandparents and their grandchild or grandchildren, if the parents of that grandchild or those grandchildren, who qualify as the children of the grandparents, are deceased as of the date of purchase or transfer. All parents do not have to be deceased. The child of the grandparent need only be single. As of January 1, 2006, if the child is married to a step-parent of the grand-child, a grandparent to grandchild exclusion will also apply.

4. Transferring the base year value of one’s home (original property) to a replacement property for persons over 55 or disabled persons who sold their original property pursuant to criteria in Section 69.5. Section 69.5 also allows a county board of supervisors, after consultation with affected local agencies located within the boundaries of the county, to adopt an ordinance that authorizes the transfer, subject to the conditions and limitations of this section, of the base year value of property that is located within another county in the State of California. Currently there are 8 counties (Alameda, San Diego, Santa Clara, Los Angeles, San Mateo, Ventura, Orange and El Dorado) that have ordinances permitting intercounty transfers of base year values. Since the counties authorizing the transfers are subject to change, it is recommended you contact the county to verify current eligibility.

5. Transferring real property to a spouse per Section 63, or transferring real property into a trust where the trustor/transferor is the sole present beneficiary of the trust or the trust is revocable by the trustor pursuant to subdivision (d) of Section 62.

6. Transferring real property to a partnership or other legal entity by maintaining exactly the same proportional interests of the transferors and transferees, resulting solely in a change in the method of holding title, under Section 62(a)(2).

**Reduction of value.** Assessors must recognize declines in value. Under Section 51, the “taxable value” is the lower of the base year value (compounded annually) or the full cash value (defined in Section 110) whichever is less. It may be necessary for the property owner to expressly bring the decline in value to the assessor’s attention. The county board of equalization is required to hear applications for reduction in assessment.

**Exemptions**

There are numerous properties that are assessed but are partially or totally tax-exempt, as well as some kinds of real and tangible business and personal property that are neither assessed nor taxed. Under Section 218, the homeowner’s exemption of the first $7,000 of full value applies to each residential property that is owner-occupied on the lien date and meets other qualifying tests. (This includes an owner-occupied unit in a multiple unit residential structure, an owner-occupied condominium, cooperative apartment, or unit in a duplex). Once claimed, the homeowner’s exemption remains in effect until terminated. Termination of the homeowner’s exemption can be triggered by a change in title-holder, even if temporary. Each homeowner is responsible for notifying the assessor that the property is no longer eligible for exemption. An escape assessment plus a 25 percent penalty and interest may result from failure to notify the assessor of the ineligibility.

Section 205 provides an exemption of up to $4,000 of full value of any property subject to property tax (real, personal, boats, planes, etc.) owned by qualifying veterans or the unmarried spouses of deceased veterans. This exemption results in a tax savings of up to $40. The limitations are that it cannot apply to a property on which the homeowner’s exemption has been successfully claimed. And for a non-home owning veteran to qualify, there is a personal wealth cap of $5,000 for an unmarried veteran and $10,000 for a married veteran. In computing the $5,000 or $10,000 property limitation, one-fourth of the assessed value of the taxable property and the full value of nontaxable property is used. Section 205.5 provides an exemption for disabled veterans and/or their unmarried surviving spouses, as follows: depending on veteran’s income and extent of disability (resulting from injury or disease incurred during military service), a disabled veteran may receive an exemption of $40,000, $60,000, $100,000, or $150,000 of the full cash value of his/her residence. The county assessor can provide application forms and other information regarding the disabled veteran’s exemption.

All growing crops, fruit, and nut-bearing trees less than four years old and grapevines less than three years old are exempt. Properties held or exclusively used for human burial or owned by nonprofit entities, including certain nursery and kindergarten-to-12th grade schools, hospitals, churches, nonprofit private schools and
colleges are exempt. Timber is no longer subject to property tax, but owners pay a yield tax on downed or felled timber. However, timberland remains taxable. Public open-space lands used solely for recreation are also exempt.

**Supplemental Assessments**

New procedures for enrolling adjustments to assessed valuations of real property have been used by assessors since 1983. Prior to the enactment of the supplemental assessment system, when a change in ownership or completed new construction occurred, increases in base year value were often delayed from 4 to 16 months, resulting in an unwarranted reduction in taxes for some, with a proportionate (and inequitable) shift of the tax burden to others.

The Legislature solved this inequity through Sections 75, et seq., under which assessors appraise at its full cash value real property which has changed ownership or is newly constructed as of the date of the event. Added taxes become due on the date the change in ownership occurs or the new construction is completed. This is done by issuing a supplemental assessment to be added to a supplemental tax roll. The value determined becomes the new base year value of the transferred or newly-constructed property. Just as for regular assessments, there are appeal procedures for protesting supplemental assessments.

If reassessment takes place between January 1st and May 31st, inclusive, two supplemental assessments are made (and the taxpayer receives two supplemental bills). A reassessment occurring between June 1st and December 31st, inclusive, generates only one supplemental assessment.

If a property changes ownership more than once during an assessment year, or if there are multiple completion dates for new construction during an assessment year, or any combination of transfers and construction, a supplemental assessment is made for each occurrence.

Supplemental assessment of property that has decreased in value results in the auditor issuing a partial refund of taxes paid in advance. The refund is sent to the new owner, not the original taxpayer. In the event of a foreclosure and a subsequent sale the refund will be prorated.

New construction is excluded from supplemental assessment (under the “builder’s inventory exclusion – Section 75.12) if the owner will not occupy but intends to market the improvement, and has so notified the assessor in writing prior to or within 30 days of the date of commencement of construction. When the newly-constructed improvements are transferred, leased or rented, a supplemental assessment is made as of that date.

County assessors are generally alerted to changes in ownership and construction starts through recorded documents and permits. When the assessor determines that an ownership change or new construction completion has occurred, the assessor:

1. places the supplemental assessment information on the roll;
2. notifies the auditor, who places an appropriate notation on the current roll or on a separate document kept with the roll; and
3. sends a prescribed notice of supplemental assessment to the assessee.

The notice includes the new base year property value, the taxable value appearing on the current roll and/or roll being prepared, information concerning the assessee’s right to review and to appeal the supplemental assessment, and the procedure for filing a claim of exemption. If the property has decreased in value and the supplemental assessment is a negative amount, the notice will advise the assessee that a refund will be made.

**Filing a Change in ownership Statement.** Section 480 requires that any person acquiring any interest in real property or a manufactured home taxed as real property must file a change in ownership statement with the county recorder or assessor. The change in ownership statement must be filed either at the time of recording, or if the transfer is not recorded, within 45 days of the date of the change in ownership. Failure to file a change in ownership statement within 45 days from the date of a written request by the assessor will result in a penalty of one hundred dollars or ten percent of the taxes applicable to the new base year value, whichever is greater.

If the transfer is occasioned by a death, and probate is not involved, the transferee (or trustee, if applicable) has 150 days from the date of the death to file the change in ownership statement. If the property is subject to probate, the statement must be filed prior to or at the time the inventory and appraisal are filed with the court.
Sections 480.3 and 480.4 require that county assessors and recorders make available to property buyers a “Preliminary Change of Ownership Report” form. This form is to be completed by the buyer prior to transfer of the property. If a document evidencing a change of ownership is presented to the recorder for recordation without the concurrent filing of this preliminary change of ownership report, the recorder may charge an additional recording fee of twenty dollars.

**Statute of limitations on Escape and Supplemental Assessments.** Section 532 provides assessors a four-year statute of limitations for the enrollment of escape assessments. In cases of concealment or not filing a change of ownership statement for an unrecorded change of ownership the statute of limitations is eight years. The enrollment period is unlimited when a change of ownership statement is not filed for a recorded change of ownership.

Section 75.11 (d) allows assessors four years to enroll supplemental assessments or eight years in cases of concealment or not filing a change of ownership statement for an unrecorded change of ownership. The enrollment period is unlimited in case of fraud.

In both cases, the statute of limitations for making escape and supplemental assessments does not begin to run until July 1 of the assessment year in which the event occurred. Where, for example, a change in ownership occurred in 1992, and a change in ownership statement reporting it was filed, the assessor has only four years from 1992 to enroll escape and supplemental assessments. If the change in ownership statement reporting it was not filed, then assessor must enroll escape and supplemental assessments for all of the years since 1992, including the year of discovery. The assessor’s statute of limitations does not commence until July 1 of the assessment year in which the event occurred.

If non-reporting occurs because of a fraudulent act or omission, the penalty of 75 percent of the additional assessed value under Section 504 is added to the escape and supplemental assessments. The supplemental assessment must be made within eight years, on or before the eighth July 1 following the July 1 of the assessment year in which the event giving rise to the supplemental occurred, and the escape assessment must be levied eight years after the July 1 of the year in which the property escaped taxation.

**Postponement (Sections 20581, et seq.)**

Senior citizens (62 years of age or older) and persons who are blind or disabled may defer payment of taxes on their residences. To qualify, an individual must own and occupy the home, have at least a 20% equity in the property (using the assessor’s full value as the standard), and have a yearly total household income of $35,500 or less for calendar year 2007. If married, only one spouse need qualify.

In applying the law, a lien in favor of the State of California is placed against the property and an interest rate determined by the rate earned by the Pooled Money Investment Fund is charged. The postponed taxes and interest are not recovered until the property is sold.

Complete information about the deferral program is available from the State Controller’s Office at P.O. Box 953, Sacramento, CA 95812. The toll free telephone number is 1-800-952-5661. Information is also available on the California State Controller’s website at [http://www.sco.ca.gov/col/taxinfo/ptp/index.shtml](http://www.sco.ca.gov/col/taxinfo/ptp/index.shtml).

**Tax Sale (Sections 3351 - 3972)**

County tax collectors, not assessors, are charged with the responsibility of administering the law pertaining to the sale of all properties that are “tax-defaulted” when five or more years have passed since the property taxes were paid. The tax collector is required by law to attempt to sell within two years all properties which have become tax defaulted and subject to the power to sell. The tax collector may sell properties to any person at a public auction or under special circumstances, to adjoining property owners at a sealed bid sale. The minimum price at which property may be sold at public auction is the sum of all taxes, penalties, costs and fees as defined.

The minimum bid has to be approved by the County Board of Supervisors. After authorization by the State Controller, the tax collector publishes or posts the required notices, setting the date of sale. At the sale, the amount of the highest bid must be paid in cash or negotiable paper, or any combination thereof which the tax collector specifies. Upon completion of the tax sale, the purchaser receives a tax deed conveying title free of all encumbrances of any kind existing before the sale, except those shown in Section 3712.
If a tax-defaulted property is unusable because of size, location, or other conditions, the tax collector may sell it at a sealed bid sale to contiguous property owners at a price established by the tax collector.

Buyers of tax-defaulted properties may include taxing agencies, revenue districts, and certain non-profit organizations. In the case of residential property, the sale to a non-profit organization is conditioned upon the rehabilitation and subsequent sale of the property to low-income persons. In the case of vacant property, the non-profit organization must either construct a residential building on the property and sell the property to low-income persons or dedicate the vacant property to public use.

**Redemption (Sections 4101, et seq.)**

Tax-defaulted real property may be redeemed upon payment of taxes, interest, costs and redemption penalties. Redemption payment is made to the county tax collector, who then issues a certificate of redemption as evidence of payment. Any person may elect to pay delinquent taxes in installments under article 4217 at any time prior to 5 p.m. on June 30 of the fifth year after the property became tax defaulted.

Delinquent taxes, costs, interest and penalties may be paid in five annual installments if the current taxes are paid. Persons electing to pay delinquent taxes in installments may be subjected to a fee for processing their request.

If the property has not been redeemed within five years after the initial declaration of default, the property will become subject to the tax collector’s power to sell. The right of redemption terminates at the close of business on the last business day prior to the date a tax collector’s auction begins. If the property is not sold, the right of redemption is revived. If the property is redeemed, the tax collector will execute and record a “Rescission of Notice of Power to Sell Tax-Defaulted Property.”

**TAXATION OF MOBILEHOMES**

Mobilehomes and manufactured homes are subject to local property taxation under prescribed circumstances.

Under Section 18551 of the Health and Safety Code there are four principal prerequisites for transforming a mobilehome into real property:

1. obtaining a building permit;
2. attaching the mobilehome to an approved foundation;
3. recording a document reflecting that the mobilehome has been affixed to an approved foundation system; and
4. obtaining a certificate of occupancy.

A mobilehome installed on a foundation system is deemed a fixture or improvement to the real property.

Section 5802 provides that the base year value of a mobilehome converted from the vehicle license fee to local property tax shall be its full cash value on the lien date for the fiscal year in which it is first enrolled.

After a mobilehome is attached to a foundation system, the Department of Housing and Community Development (HCD) must cancel the registration. Title is thereafter recorded with the county recorder and ownership is transferred accordingly. Removal of the mobilehome from the foundation is prohibited unless the following conditions are met:

1. all persons having title to any estate or interest in the real property consent to the removal; and
2. 30 days prior to removal, the owner of the mobilehome notifies HCD and the local assessor of its intended removal.

HCD must be given written evidence of the consent to removal by all persons having title or interest in the real property. HCD will then require the owner to obtain a transportation permit or mobilehome registration, whichever it deems appropriate. Once removed from the foundation and the HCD license fee is paid, the mobilehome is personal property and the assessor will remove it from the real property tax roll.
**SPECIAL ASSESSMENTS**

Special assessments are levied for the cost of a public improvement or services such as streets, sewers, irrigation, and drainage. Special assessments may be due periodically to improvement districts or be levied only once by the city or county for a particular work or improvement. These assessments are not based on the value of the property.

The liens created by special assessments are usually equal in priority to general tax liens.

Self-governing districts may be the source of special assessments. Activated under state law by the local city or county or by vote of the residents, the district becomes a separate legal entity governed by a board of directors.

A district issues bonds to finance particular improvements such as water distribution systems, drainage structures, irrigation works, or parking facilities. To pay off the bonds, the district has the power to assess all lands included in the district on an ad valorem basis. This assessment is a lien on the land until paid. The lien has priority over private property interests and can be foreclosed by sale similar to a tax sale.

**Benefit Assessments**

Rather than establishing a separate district for the purpose of constructing an improvement, the city or county may establish an “improvement area” and assess the lands contained therein on the basis of benefits to be received from the proposed improvement. A benefit assessment is often included on the property tax bill.

Benefit assessments are distinguished from special assessments chiefly by the differences in the assessment base. However, there are other distinguishing characteristics. Benefit assessments are generally not considered to be deductible as a tax on either California or federal income tax returns. There is a distinction made in federal tax regulations between an assessment to finance improvements and an assessment to finance maintenance. Only the latter is deductible.

The purposes for which benefit assessments are levied include lighting, flood control, transit, police protection, fire protection, county service areas and paramedics.

**CERTAIN ASSESSMENT STATUTES**

Since 1885, California has enacted numerous statutes relating to special taxes and assessments and to the formation of assessment districts throughout the state. The following are among the important assessment acts.

**Vrooman Street Act**

Passed in 1885, this act conferred authority on city councils to grade and finish streets, construct sewers, etc., within municipalities or counties. It provides for an election and the issuance of bonds secured by special funds collected under tax levy. It also provides for the acquisition of public utilities by the municipality or county.

A property owner may arrange for street grading according to official specifications and secure a reduction in the amount of the assessment.

**Street Improvement Act of 1911**

This act is utilized more than any other for street improvements in this state. Assessments are due in equal installments during the term of the bonds. The local legislative body determines the rate of interest on the bonds. The amount of assessment appears on the tax bill as a lien against the property. It may be partially or wholly prepaid at any time, including prior to issuance of the bonds.

**The Improvement Bond Act of 1915**

Under the terms of this act, a public agency can issue bonds to finance subdivision street improvements. Bonds usually carry a maximum of 6 percent interest. Owners of affected property bear the cost to redeem the bond. Under certain circumstances, an improvement district cannot issue bonds until the California Districts Securities Commission has approved the project.

**Mello-Roos**

The Mello-Roos Community Facilities Act of 1982 provides for a wider variety of facilities and services than other improvement bond acts and has no requirement that such improvements will specifically benefit individual properties. Although a Mello-Roos assessment is secured by a lien against the property and the maximum tax rate approved may be greater than what will be needed to retire the bonds, the principal amounts
of the bonds are not tied to any specific parcels. As such, Mello-Roos is on the order of a general property tax levy for general fund benefits and is not appropriate for inclusion in the land value of the parcels. The amount of any unpaid assessment(s) will not appear on the property tax bill, but will be separately levied and collected. Civil Code Section 1102.6b requires that a seller of one to four dwelling units disclose a Mello-Roos assessment.

FEDERAL TAXES

Federal Tax Liens
Any unpaid Internal Revenue Code tax becomes a lien on all property and rights to property of the taxpayer, including property or rights to property acquired after the lien arises. A federal tax lien is not valid against purchasers, holders of security interests (e.g., mortgages or mechanics’ liens) and judgment lien creditors until a notice of lien has been filed in the proper place. Even though a notice of lien has been filed, it is not valid against certain classes of creditors (known as “Super Priorities”) defined in Section 6323(b) of the Internal Revenue Code. With respect to real property, the notice must be filed with the county recorder.

In addition to the general tax lien, the Internal Revenue Code provides for special liens for estate and gift taxes. At the date of the decedent’s death, an unrecorded estate tax lien attaches to every part of the gross estate and continues for a period of ten years. An estate tax lien is valid against most purchasers and transferees. (If the estate elects to pay the tax in installments for up to fifteen years, the lien is recorded.)

An unrecorded gift tax lien attaches to all gifts made during the calendar year. If the gift tax is not paid by the donor, the donee becomes personally liable for the tax. The gift tax lien extends for ten years from the time the gifts were made.

Federal Gift Tax and the Unified Credit
This tax applies to completed voluntary transfers by an individual of any type of property for less than an adequate and full consideration in money or money’s worth.

If a gift is a transfer of a present interest, there is an annual exclusion of $13,000. If a gift exceeds $13,000 in a year, a return is due. If the gift is a transfer of a future interest (i.e., any interest that is to commence in use, possession, or enjoyment at some future time), the exclusion does not apply and a return is due.

Two types of “indirect” transfers are no longer considered gifts and no return is due. These include any amount paid on behalf of an individual:
1. as tuition to an educational organization; or
2. to any person who provides medical care.

The due date of the Federal Gift Tax Return is April 15 of the year following the gift. Any extension of time granted for filing the form 1040 applies to the return. Any compliance questions should be referred to a tax advisor or the local IRS office.

Even though a return may be due, there may not be a tax liability. For example, transfers between spouses are not taxable gifts. Also, donors may make large transfers and use their Unified Credit rather than pay the gift tax. The Unified Credit is a dollar for dollar offset against the tax. It was phased in as follows:

<table>
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<tr>
<th>Year</th>
<th>Unified Credit</th>
<th>Applicable Exclusion Amount</th>
<th>For Gift Tax Purposes:</th>
<th>Unified Credit</th>
<th>Applicable Exclusion Amount</th>
<th>For Estate Tax Purposes:</th>
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<td>345,800</td>
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<tr>
<td>2004 and 2005</td>
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<tr>
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<td>1,455,800</td>
<td>3,500,000</td>
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<td></td>
</tr>
</tbody>
</table>

To the extent the Unified Credit is used to offset a gift tax liability, it is unavailable for offset in settlement of the transferor’s estate tax liability.
Social Security Tax

The federal government operates a retirement pay program. Self-employed persons are generally covered also. This program, commonly known as “social security,” requires quarterly contributions by almost all employers.

Federal Insurance Contributions Act (FICA) withholdings are employee contributions to social security and medicare. An employee’s FICA tax rate is 7.65%. The social security tax portion is applied to wages up to a certain amount (e.g., $106,800 for 2010). The medicare portion applies to all wages.

Unemployment Tax

This federal tax is applicable only to those non-farm employers who:

1. pay wages of $1,500 or more during any calendar quarter; or
2. employ at least one employee for some portion of at least one day of each of at least 20 different weeks (not necessarily consecutive) during the current or the preceding calendar year.

There are also specific requirements for those individuals employing agricultural or domestic workers.

DOCUMENTARY TRANSFER TAX

Section 11911 allows a county or city to adopt a documentary transfer tax to apply to transfers of real property located in the county. Notice of payment is entered on the face of the deed or on a separate paper recorded with the deed.

The tax is computed at the rate of 55 cents for each $500 of consideration or fraction thereof. If a portion of the total price paid for the property is exempt because a lien or encumbrance remains on the property, this fact must be stated on the deed or on a separate paper filed with the deed. Certain types of property transfers, such as inter vivos gifts, transfers by reason of death, or proportional transfers into a partnership owned by the same individual or entity, are exempt from documentary transfer tax.

A city within a county which has adopted a transfer tax may also adopt its own transfer tax ordinance with the tax amount fixed at one-half the rate charged by the county. The county collects the total tax in the amount recited above but turns half the amount collected over to the city.

Some cities collect transfer taxes in excess of the amounts provided in Section 11911. In part, the authority for this may lie in the distinction between charter cities and general law cities. A concerned party should contact the recorder’s office for the status of a particular city’s transfer tax levy.

STATE TAXES

Inheritance Tax

The inheritance tax law was repealed as the result of the passage of Proposition 6 at the California election held on June 8, 1982. The new estate law (below) is effective for estates of decedents who died after January 1, 1987.

Gift Tax

The gift tax law was also repealed as the result of the passage of Proposition 6 at the California election held on June 8, 1982. The repeal is effective as to all gifts made after June 7, 1982.

Estate Tax

Proposition 6 also enacted the California estate tax. The purpose of this tax is to take advantage of a provision in federal law which allows the estate to claim a credit against the federal estate tax for death taxes paid to the state. The tax is fixed in the maximum amount that the federal government will allow as a credit for estate taxes paid to the state. Therefore, this tax does not cost the estate anything because if the amount were not paid to the state it would have to be paid to the federal government.

A California Estate Tax Return is required to be filed with the State Controller for the estate of every decedent whose date of death is after January 1, 1987, if a Federal Estate Tax Return is required to be filed. The return is due and any tax liability is payable on or before nine months after the date of death. There is a late filing penalty of 5% of the amount of the tax due for each month or portion thereof up to a maximum of 25%. This penalty can be waived for good cause. If an extension to file has been granted by the Internal Revenue Service
for the filing of the Federal Estate Tax Return, a like extension will be given for the California return. In addition to the late filing penalty, interest at the rate of 12 percent per annum is chargeable on payments not made within nine months after the decedent’s death.

MISCELLANEOUS TAXES

Sales and Use Tax
The California State Sales Tax is imposed upon retailers for the privilege of selling tangible personal property at retail. The retailer is liable for this tax whether or not collected from customers.

The Use Tax is imposed upon the storage, use, or other consumption of tangible personal property purchased or leased under certain conditions from a retailer. Use Tax is the liability of the purchaser and that liability is not extinguished until the tax is paid to the state unless it was paid to, and a receipt for the tax was obtained from, a retailer who is registered with and authorized by the state to collect the tax from the purchaser. Sales or Use Tax also applies to certain leases of tangible personal property under specific conditions. The State Board of Equalization administers these taxes.

A real estate broker may be concerned with the tax on sale of personal property. The tax applies to transfers of buildings and the personal property which may convey with the sale of a house and which are not considered occasional sales under the law if, pursuant to the contract of sale, the buildings are to be severed by the seller. If the contract of sale requires they be severed by the purchaser, the transaction is not taxable as a sale of tangible personal property. The tax may also apply to the value of machinery, equipment and fixtures that do not constitute occasional sales, when included with the sale of a building.

Where a business which required a seller’s permit is being sold, the purchaser may be held liable as a successor for tax owed by the seller. If there is any question, sufficient money should be held in escrow to cover possible sales tax liability until a tax clearance is received from the State Board of Equalization.

Real Estate Broker and Mobilehome Sales
A real estate broker who sells mobilehomes as a retailer is required to hold a seller’s permit and report to the Board of Equalization the sales or use tax applicable to these transactions. When such a broker sells a new mobilehome for occupancy as a residence, the broker is classified as a retailer-consumer and is required to declare and pay tax on 75% of the broker’s purchase price of the mobilehome. Unattached furnishings and other items that are not part of the mobilehome unit remain subject to tax at the full retail selling price unless otherwise exempt.

A real estate broker who sells used mobilehomes as a retailer is also required to hold a seller’s permit. The application of tax to sales of used mobilehomes depends on whether the unit is subject to property tax or is exempt, but sales tax would apply to any accessory items sold that are not a component part of the mobilehome unit. For mobilehome units sold that are not subject to property tax, sales tax applies. When a real estate broker acts as agent only, the purchaser is subject to use tax. If the mobilehome is subject to property tax, neither the sales or use tax applies.

Any questions should be referred to the nearest office of the Board of Equalization.

Real estate salesperson and broker exclusion. Services performed as real estate salespersons and brokers are excluded from covered employment for purposes of UI, ETT, DI and PIT withholding, if all of the following conditions are met:

1. The individual must be a licensed real estate broker or salesperson;
2. Substantially all of the remuneration paid to the individual is based on sales or other output rather than by the number of hours worked by the individual; and
3. There is a written contract between the individual performing the services and the person for whom the services are performed; which contract provides that, for purposes of state taxes, the individual performing the services will not be treated as an employee.
**State Tax Lien Law**

Under applicable State law, any tax liabilities which become due and payable, including penalties and interest, together with any costs, constitute an enforceable State tax lien on all real property located in this State. However, the lien is not valid against:

1. a successor in interest of the taxpayer without knowledge of the lien;
2. a holder of a security interest;
3. a mechanic’s lienor; or
4. a judgment lien creditor where the right, title, or interest was acquired prior to the recording of the State tax lien.

(Government Code Sections 7150-7229)

**Unemployment Insurance Tax**

The California Unemployment Insurance (UI) Code requires contributions by employers for a national system of unemployment insurance. Employers must also pay an employment training tax (ETT) and withhold state personal income tax (PIT) and disability insurance (DI) from employees’ wages.

Real estate salespersons and brokers who are employees under common law rules and whose services are not excluded, are subject to UI, ETT, DI and state PIT withholding. For further information about services in excluded employment or in determining if an individual is an employee or an independent contractor, contact the State Agency Employment Development Department.

**California worker’s compensation law.** An employer’s statutory liability toward an employee injured on the job is covered by worker’s compensation insurance. While not technically a tax, it is included in this section because it does involve payments by the employer. This insurance provides for weekly benefit payments to employees unable to work as the result of an industrial injury or illness, as well as payment of all medical and hospital costs in connection therewith.

Since California law is very specific about which employees must be covered, employers should be familiar with Sections 3351-3700 of the California Labor Code. Problems are most likely to arise in the areas of independent contractors and part-time employees. Additional information about the law and coverage can be obtained from State Compensation Insurance Fund.

**ACQUISITION OF REAL PROPERTY**

Tax planning is a key consideration in an analysis of the potential returns and risks of a real estate project. Investors usually seek to:

1. shelter income from taxes; or
2. generate losses to shelter other earned income; or
3. obtain favorable capital gains treatment at disposition.
4. deferral of tax liability.

The manner in which an investor acquires real property can contribute to one or more of these goals.

Recent tax reforms have tended to eliminate most acquisition tax write-offs (e.g., prepaid interest) and there are probably few immediate tax effects resulting from the mere acquisition of property. However, the method of acquisition usually has important tax consequences at sale or other disposition of the property.

Title might be taken through a corporation or individually as community property, joint tenancy or tenancy in common. Corporate ownership permits dealers to segregate their investment property from their stock in trade and establish the true nature of each type of property. On the other hand, individual ownership allows greater maneuverability if future plans are uncertain because the property can later be transferred to a corporation tax-free.

If the taxpayer is in a relatively low tax bracket, individual taxes, particularly for a married person, will be less than corporate taxes on a given amount of income. Although joint tenancy ownership will simplify processing on death and reduce probate costs, the transfer of joint tenancy property cannot be controlled by will and the half not included in the decedent’s gross estate does not receive a step-up in basis.
**Adjusted Tax Basis**

One of the most important factors in determining the amount of ultimate gain or loss on a transaction is the “adjusted tax basis” of property, based on its original acquisition price. Property purchased has a basis equal to the purchase price paid, adjusted for various items over the life of the property (e.g., depreciation). Property received as a gift has a basis of the donor’s cost (or market value at date of gift if this is lower and taxpayer desires to claim a loss). The beginning basis of property acquired from a decedent is generally the fair market value at the date of death.

**Tax Planning**

The subject of income taxation in connection with real estate sales frequently arises in the context of ex-post reporting of the facts. In most instances, once a tax related choice is made, it cannot be altered at the time of filing a tax return. It is then too late to think about tax planning.

The price of a property may be less important than the financial or tax position of the buyer or seller for purposes of developing acquisition and/or disposition strategies. Tax planning should start in the pre-acquisition stage. Real estate has historically enjoyed a favorable position in both federal and state income tax laws, but receipt of the available benefits requires tax awareness during the events leading up to acquisition and continuing through the entire period of ownership.

**Broker’s role.** There are many subtleties in the tax laws relating to real estate income. Unless a real estate broker is also an income tax investment counselor, the broker should never offer tax advice but should urge clients to consult a real estate tax attorney, certified public accountant or other qualified person.

**INCOME TAXATION**

**Federal Income Tax**

While the Tax Reform Act of 1986 reduced most tax rates and simplified the rate structure, certain real property tax benefits were changed or repealed. The 60% deduction for long-term capital gain was repealed and capital gain was treated as ordinary income and taxed at a rate no higher than 28%. Mortgage interest also became subject to different rules that could limit its deductibility, especially if the home was refinanced, or a second mortgage, home equity loan, or line of credit was obtained. The rules regarding depreciation also changed, so that all tangible property placed in service after December 31, 1986 was subject to the modified acceleration cost recovery system (MACRS).

The Taxpayer Relief Act of 1997 changed the overall capital gains tax rate. The top rate for high income earners was lowered from 28 percent to 20 percent. The lowest bracket was reduced from 15 percent to 10 percent. The new rates apply to assets sold after May 6, 1997. Investment property owners will experience slightly different treatment regarding depreciation recapture under the new tax bill than in previous years. The difference between the purchase price and selling price (profit) of a property will enjoy the lower overall capital gains tax rate, but any gains due to depreciation recapture will be taxed at 25 percent. Individual taxpayers will need to consult their tax specialist to determine the application of the new law to their investments.

Starting with 2008, there’s a new **zero percent** tax rate on long-term capital gains. The zero percent rate applies to individuals who are in the 10% and 15% marginal tax brackets. The zero percent rate is scheduled to expire at the end of 2010, when capital gains rates will increase to at least 15%.

**Capital Gains Tax Rates**

<table>
<thead>
<tr>
<th>Type of Capital Asset</th>
<th>Holding Period</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term capital gains (STCG)</td>
<td>One year or less</td>
<td>Ordinary income tax rates up to 35%</td>
</tr>
<tr>
<td>Long-term capital gains (LTCG)</td>
<td>More than one year</td>
<td><strong>5%</strong> for taxpayers in the 10% and 15% tax brackets (zero percent starting in 2008)</td>
</tr>
</tbody>
</table>
<pre><code>                                                             | **15%** for taxpayers in the 25%, 28%, 33%, and 35% tax brackets |
</code></pre>
**Passive activity losses and credits.** Before the Tax Reform Act of 1986, taxpayers, with some limitation, could use deductions from one activity to offset income from any other activity. Similarly, most tax credits generated in one activity could be used to offset tax on income from any of the taxpayer’s other activities.

In response to concerns that extensive tax shelter activity was unfair, Congress enacted the passive activity loss (PAL) rules.

After 1986, income was separated into three categories: non-passive income, portfolio income, and passive income. As a result of these PAL rules, taxpayers generally cannot offset non-passive or portfolio income with losses from passive activities. Nor can they offset taxes on such income with credits from passive activities. The new law does contain exceptions for certain activities, including rental real estate, and also has phase-in rules for some losses.

A passive activity generally is any activity involving the conduct of any trade or business in which you do not *materially participate*. In addition, any rental activity is a passive activity regardless of whether you materially participate. For this purpose, a rental activity generally is an activity the income from which consists of payments principally for the use of tangible property, unless substantial services are performed in connection therewith. A taxpayer materially participates in an activity if the taxpayer is involved on a regular, continuous, and substantial basis in the operation of the activity.

**At-risk rules extended to real property.** The at-risk rules have been extended to apply to the holding of real property. The at-risk rules place a limit on the amount of deductible losses from certain activities often described as tax shelters. Until 1987, activities associated with holding of real property (other than mineral property) were not subject to the at-risk rules.

The at-risk rules apply to losses incurred through real property placed in service after 1986. In the case of an interest in an S corporation, a partnership, or any other pass-through entity acquired after 1986, the at-risk rules apply to real estate activities regardless of when the entity placed the property in service.

In general, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount the taxpayer has at-risk in the activity at the end of the tax year. A taxpayer is considered at risk in an activity to the extent of cash and the adjusted basis of other property the taxpayer contributed to the activity and certain amounts borrowed for use in the activity.

A taxpayer is not considered at risk for amounts protected against loss through nonrecourse financing. Nonrecourse financing is financing for which the taxpayer is not personally liable. However, an exception applies to qualified nonrecourse financing secured by real property used in an activity of holding real property. *Qualified nonrecourse debt* is debt for which no one is personally liable and that is:

1. borrowed by the taxpayer with respect to the activity of holding real property;
2. secured by real property used in the activity;
3. not convertible from a debt obligation to an ownership interest; and
4. a loan from, and guaranteed by, any federal, state, or local government, or borrowed by the taxpayer from a qualified person.

A *qualified person* is a person who actively and regularly engages in the business of lending money. The most common example is a bank. A qualified person is not:

1. a person related to the taxpayer (except as described later);
2. the seller of the property, or a person related to the seller;
3. a person who receives a fee due to the taxpayer’s investment in the real property, or a person related to that person.

A person related to the taxpayer may be a qualified person if the nonrecourse financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons.
Depreciation
Depreciation is a deductible periodic accounting charge that represents the recovery of capital investment over the useful life of property used in a trade or business or other income producing activity. Land is not included, as it does not depreciate.

For depreciable properties acquired prior to January 1, 1981, the principal methods for computing depreciation are straight-line, declining balance and sum-of-the-years’ digits.

For depreciable properties acquired on and after January 1, 1981 and before August 1, 1986, depreciation is computed under a method called accelerated cost recovery system (ACRS), permitting cost recovery over much shorter periods.

The Modified Accelerated Cost Recovery System (MACRS) must be used to depreciate property placed into service after 1986. Taxpayers need to consult their tax advisors for more information on any changes in the depreciation schedules that have been effected since 1986.

Appraisal and income tax concepts. Depreciation for tax purposes is to be distinguished from depreciation for appraisal purposes. In appraisal practice, depreciation is loss in value due to any cause, including functional obsolescence or physical deterioration. For income tax purposes, depreciation is a possible annual deduction from taxable income in recognition of the fact an asset may become economically obsolete or wear out physically and the owner has the right to recover his investment.

Improvements to real property are depreciable for income tax purposes if they are used in business or held for the production of income and have a determinable life longer than one year.

Even if a taxpayer does not take a deduction for depreciation, the basis of the property is reduced by the amount of the depreciation. Upon sale, the IRS charges the taxpayer with the full amount of depreciation the taxpayer could have taken.

Home Mortgage Interest Deduction
For years beginning after 1987, the rules for deducting mortgage interest have been modified. The amount of interest a taxpayer may deduct depends on the date, amount, and use of the loan.

In general, the interest on any loan obtained before October 14, 1987 and secured by a main or second home is fully deductible.

If a taxpayer obtained a first loan after October 13, 1987 to buy, build, or substantially improve a main or second home, interest is deductible on the first $1 million of principle ($500,000 if married filing separately). Interest may be deductible on up to $100,000 of junior loan(s) secured by a taxpayer’s main or second home.

For more information, see IRS Publication 936, Limits on Home Mortgage Interest Deduction.

Mortgage Credit Certificates
State and local governments sometimes issue mortgage credit certificates (MCCs). Under any such program, MCCs may be issued until a total dollar amount set by the state or local government is reached. An MCC allows a borrower to use mortgage interest as a credit against income tax, making it easier for a low or moderate income person to qualify for a loan for acquisition, qualified rehabilitation, or qualified home improvement of a residence.

Disposition of Real Property - Tax Effects
The characterization and tax treatment of a sale of real property depend upon the use to which the transferor put the property.

Sales or exchanges must be reported to the Internal Revenue Service on Form 1099-S, Statement for Recipients of Proceeds from Real Estate Transactions.

Capital gain is the taxable profit derived from the sale of a capital asset (generally, that property of a taxpayer other than inventory). The gain is calculated as the sales price reduced by the adjusted basis, expenses of sale, and closing costs. Adjusted basis is the original tax basis of the property adjusted for capital improvements, depreciation and fixing-up expenses.
The capital gains deduction was repealed for tax years beginning after 1986. Although set to increase in 2011 tax year, currently long term net capital gains generally will be taxed at a rate no higher than 15%.

**Special rules - sale of personal residence.** Until the passage of the Taxpayer Relief Act of 1997, a taxpayer was only permitted to postpone the gain on sale of principal residence by way of a one time only $125,000 exemption on the sale of his/her principal residence if the taxpayer was age 55 or older and had resided in the home for at least three of the last five years. The principal residence replacement rule required the taxpayer to purchase another principal residence of equal or greater value and use it within two years before or after sale of the previous principal residence. The original gain was not recognized at the time of sale but was used to reduce the cost basis of the new house.

The Taxpayer Relief Act of 1997 granted a $500,000 capital gains tax exclusion to couples and a $250,000 exclusion to single filers, who sell their principal residence. The bill specified that:

The “rollover” and “over 55” requirements were repealed.

Individuals must have lived in the house for two of the last five years. For purposes of the exclusion, on sales after September 30, 1988, taxpayers who are mentally or physically incapacitated are treated as occupying the principal residence while they are in nursing homes or similar care facilities, as long as the principal residence is actually occupied for periods aggregating at least one year of the applicable five-year period. The facility must be licensed by a state or political subdivision to care for individuals in such condition. [Internal Revenue Code §121(d)(7)

The sales transaction must have taken place after May 6, 1997.

Sellers and buyers who signed a binding contract between May 7, 1997 and August 5, 1997 could apply either the old or new law into their transaction.

The new law gives buyers more options because they are no longer forced to purchase new homes of equal or greater value. Individuals who meet the requirements can sell their homes every two years and still qualify. In addition, individuals who marry someone who has already taken the “over 55” exclusion, or individuals forced to sell because of an emergency, like a job transfer or large medical bills, will be able to use the new exclusion. The new plan does not allow taxpayers to deduct losses on the sale of their property from their income tax. Individuals will need to consult their own tax advisor to determine how to apply the new law to their particular tax situation.

**1031 exchanges.** Property may be disposed of by exchange rather than sale. Some exchanges qualify as tax deferred. If the exchange does not qualify as tax-free, it is treated in all respects as a sale.

To qualify as a tax-free exchange, the properties must be “like kind” in nature or character, not in use, quality or grade. The “like-kind” rules give parties a relatively high degree of flexibility: a farm may be exchanged for a store building; vacant land for an apartment building; a rental house for a vacant parcel. Personal use real property does not qualify. A vacation property or a primary residence may qualify as “like-kind” property, and qualify for tax free exchange treatment, provided certain guidelines are followed. If a tax-free exchange has been made, neither gain nor loss is recognized at the time of the exchange, but is deferred by attributing to the property received the same cost basis as that of the property transferred. The holding period of the new property includes that of the old parcel.

Complications arise when like-kind property received is accompanied by cash or other assets (“boot”). When boot is received, gain is recognized but losses are still excluded from recognition. The taxable gain is the lesser of the value of “boot” received or the gain realized on the exchange. The result may be a fully taxable or a partially tax-free exchange.

For example: A taxpayer exchanges a fourplex with a depreciated cost basis of $190,000 for a duplex worth $194,000 plus $2,000 cash. The taxpayer’s gain is $6,000, but only a portion of this gain, the $2,000 boot, is recognized and taxable at the time of the exchange. The remaining $4,000 of gain is not recognized at this time but is postponed by leaving the cost basis of the new property at $190,000. Upon sale of the duplex, the taxpayer must recognize the $4,000 of former gain.
If one of the properties exchanged is encumbered by mortgage debt, the debt relief is treated as boot received. If both properties are encumbered, the debts are netted for the purpose of determining the amount and assignment of boot.

Of course, the principal difficulty in effecting a tax-free exchange is finding suitable properties and investors. Usually, two real estate investors are not interested in each other’s property and a multi-party exchange must be arranged.

The tax rule which requires an owner to carry over the basis of the old property as the basis for the new property is a problem when exchanging pre-1981 properties for post-1981 properties. Special rules apply to exchanges of pre-accelerated cost recovery system (ACRS) and post-ACRS properties. To avoid this problem, a taxpayer may consider selling the pre-1981 property and purchase the post-1981 property with the proceeds.

**Installment sales.** Taxpayers selling real property and receiving one or more payments in a later year or years must report the sale as an installment sale unless the taxpayer specifically elects otherwise.

By selling on multi-year terms, a taxpayer avoids bunching gain/income in the year of sale. Rather, recognition of gain is deferred by spreading it over a number of tax years.

The installment sale method may be used for any kind of real estate, including vacant land. The taxable part of installment payments is calculated by applying to each payment the profit percentage realized on the full transaction. This percentage is found by dividing the realized profit on the sale by the full contract price. IRS instructions should be followed for determining this percentage based on the contract price, selling price, gross profit and payments received.

**Example:** Real property is sold for $200,000; unadjusted basis is $132,000; selling costs are $8,000. Installment payments of $50,000 are to be made in the year of sale and in each of the next three years.

- Contract price (selling price)........... $200,000
- Less: Selling costs and unadjusted basis..... -140,000
- Gross Profit........................................... $60,000
- Gross Profit Percentage = $60,000 ÷ $200,000 = 30%

For the year of sale and each of the following three years, a profit of $15,000 (30% of $50,000) is reported.

**Leases.** Rent is taxable to the lessor as ordinary income and, for non-residential property, deductible as a business expense to the lessee. Payments by a lessee on execution of a lease may be either advance rent or a security deposit. If the former, a (non-residential) lessee has a deduction and the lessor must report the payment as income in the year paid. A security deposit remains the property of the lessee until default/forfeiture. If forfeited, the deposit is deductible by the lessee and is income to the lessor. If the lessor pays the lessee interest on the deposit, the lessee has reportable income.

If the lessee receives lease cancellation payments from the lessor, they are treated as being in exchange for the sale of the lease to the lessor. If the lease is not a capital asset, the income is ordinary income to the lessee. The lessor is treated as making an expenditure for the acquisition of a property right. The lessor’s payment must be capitalized and added to the basis of the property. If the lessor receives lease cancellation payments from the lessee, the lessee has ordinary income and the lessee treats the expenditure as a current business expense.

A lessor or lessee’s costs of procuring a lease (i.e., commissions, legal fees, and title expenses) must be prorated over the life of the lease. It should always be remembered that losses and expenses of lessees of residential property are considered personal and not deductible.

**State Income Tax**

As of January 2005, California generally conforms to the Internal Revenue Code (IRC). However, there are continuing differences between California and federal tax law. When California conforms to federal; tax law changes, not all of the tax changes made at the federal level are always adopted by California. For more information refer to [www.ftb.ca.gov](http://www.ftb.ca.gov) and search for “conformity.”