

M e m o r a n d u m

To: Honorable Betty T. Yee, Chairwoman
Honorably Judy Chu, Vice-Chair
Honorably Bill Leonard, Second District
Honorably Michelle Steel, Third District
Honorably John Chiang, Controller

Date: May 17, 2007

From: Kristine Cazadd
Chief Counsel 

Subject: **Petition for Amendment of Property Tax Rule 462.060**
Change in Ownership – Life Estates and Estates for Years
June 1, 2007 Board Meeting – Chief Counsel Matters – Item J – Rulemaking

By a letter received on May 1, 2007, Mr. Stephen Bennett petitioned the Board, pursuant to Government Code section 11340.6, to amend Property Tax Rule¹ 462.060, *Change in Ownership - Life Estates and Estates for Years*, to add a new change in ownership exclusion for the creation of life estates if the interests transferred do not meet three tests based on (a) the nature of the interests transferred, (b) the life tenants obtaining exclusive and beneficial use of the entire real property, and (c) the value of the life estates. This matter is scheduled for the Board's consideration at the June 1, 2007 meeting² on the Chief Counsel Matters Agenda. On June 1, the Board may: (1) deny the petition; (2) grant the petition in part or in whole and commence the official rulemaking process by ordering publication of the notice pursuant to Government Code section 11346.5; or (3) direct staff to commence an interested parties process to consider the requested amendment in part or in whole. Staff recommends that Board deny the petition because the current version of Rule 462.060 is consistent with Revenue and Taxation Code sections 60 and 62, subdivision (e), as well as recent appellate court decisions.

This memorandum will set forth: (1) a general background of change in ownership law regarding life estates; (2) a discussion of the petition and the requested amendment; and (3) a discussion of the staff's recommendation.

I. General Background of Rule 462.060, Subdivision (a)

Revenue and Taxation Code section 60 defines "change in ownership" as single test with three elements: "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." The third element, known as the "value equivalence" element, ensures that only transfers of property interests that

¹ All "Property Tax Rule" or "Rule" references are to title 18 of the California Code of Regulations.

² Under Government Code section 11340.7, the Board has 30 days from receipt to deny the petition in whole or in part, indicating the reasons why, or to initiate the rulemaking process. Although this petition will be heard within that 30-day deadline, petitioner has waived the deadline until the June 1 Board meeting.

represent the primary value of the real property are considered changes in ownership. Revenue and Taxation Code section 61 et seq. provides examples of transfers that result in changes in ownership and examples of transfers that do not. As relevant herein, section 62, subdivision (e), excludes from change in ownership:

[a]ny transfer by an instrument whose terms reserve to the transferor an estate for years or an estate for life. However, the termination of such an estate for years or estate for life shall constitute a change in ownership, except as provided in subdivision (d) [transfers involving trusts] and in Section 63 [interspousal exclusion].” [Parentheticals added.]

In establishing this exclusion, the Legislature placed no qualifications as to the nature or length of the life estate.

To interpret sections 60 and 62, subdivision (e), the Board concurrently promulgated Property Tax Rule 462 (the predecessor to Rule 462.060) which provided that:

(1) The following transfers do not constitute a change in ownership:

* * *

(3) Any transfer by an instrument whose terms reserve to transferor, the transferor’s spouse or both of them an estate for years or an estate for life. When such reserved estates both terminate and if the provisions of this section relating to trusts and interspousal transfers do not provide otherwise, a change in ownership shall be deemed to have occurred.

Subdivision (1) of former Rule 462 was adopted on August 16, 1979, and became effective on August 22, 1979, contemporaneously with the adoption of sections 60 and 62, which were added by statutes 1979, chapter 242, effective July 10, 1979. Current Rule 462.060, subdivision (a), retains the substance of former Rule 462, subdivision (1), as follows:

The creation of a life estate in real property is a change in ownership at the time of the transfer unless the instrument creating the life estate reserves such estate in the transferor or the transferor’s spouse. However, the subsequent transfer of such a life estate by the transferor or the transferor’s spouse to a third party is a change in ownership. Upon termination of such a reserved life estate, the vesting of a right to possession or enjoyment of a remainderman (other than the transferor or the transferor’s spouse) is a change in ownership.

Thus, as stated above, Rule 462.060 applies the plain language of section 62, subdivision (e), that the creation of a life estate is a change in ownership unless that life estate is retained by the transferor or the transferor’s spouse.³

³ Under current law, in which section 60’s definition of “change in ownership” has been modified by initiative and further clarified by the Legislature, the creation of a life estate may also be excluded from a change in ownership if any statutory exclusion applies, e.g., the parent-child or grandparent-grandchild exclusion.

A. Report of the Task Force on Property Tax Administration

The interpretation of Revenue and Taxation Code section 60 and section 62, subdivision (e), as set forth in Rule 462.060, is consistent with the recommendations of the “Report of the Task Force on Property Tax Administration” (Task Force Report), submitted to the Assembly Committee on Revenue and Taxation on January 22, 1979. In interpreting the change in ownership provisions of Revenue and Taxation Code section 60 et seq., courts have long relied on the explanations and rationales set forth in Task Force Report. (*See Pacific Southwest Realty v. County of Los Angeles* (1991) 1 Cal.4th 155, at 161-162.) The following is the Task Force Report discussion of the present interest, beneficial use, and value equivalence elements of the “change in ownership” test ultimately enacted as section 60:

Present Interest. . . . This element is necessary to protect a variety of contingent or inchoate transfers from unintended change in ownership treatment, including future interests, revocable transfers and transfers with retained life estates.

Beneficial Use. Beneficial use is necessary to protect custodianships, guardianships, trusteeships security interests, and other fiduciary relationships from unintended change in ownership treatment. . . .

Value Equivalence. The ‘value equivalence’ test is necessary to determine who is the primary owner of the property at any given time. Often two or more people have interest in a single parcel of real property. . . . [I]n determining whether a change in ownership has occurred it is necessary to identify but one primary owner . . . so that only a transfer by him will be a change in ownership and when it occurs the whole property will be reappraised.
(Task Force Report, pp. 39-40 (emphasis in original).)

Accordingly, under the three-part test described above, when two or more persons have an interest in a single parcel of real property, it is necessary to identify the one “primary owner” of the real property. In the case of life estates, the Task Force recommended, and the Legislature decided, that the life tenant is that primary owner and that the creation of a life estate is a change in ownership unless reserved for the transferor or the transferor’s spouse. (Task Force Report, p. 44; Rev. & Tax. Code, §§ 60 and 62, subd. (e).)

B. Appellate Court Decisions - Creation of a Life Estate is a Change in Ownership

Two published Court of Appeal decisions have applied Rule 462.060 to conclude that the creation of a life estate is a change in ownership: (1) *Leckie v. County of Orange* (1998) 65 Cal.App.4th 334; and (2) *Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4th 480. In *Leckie*, the Court of Appeals held that the creation of a life estate for the benefit of a 58-year old nonspousal third party is a change in ownership. The *Leckie* court determined that the creation of a life estate met the value equivalence test under section 60. To reach that conclusion, the court interpreted the plain language of subdivision (e) of section 62 to conclude that the creation of a life estate, other than those reserved for the transferor or the transferor’s spouse, is a change in ownership, upholding Rule 462.060, subdivision (a). (*Leckie, supra*, at p. 339.)

The Court of Appeal reached the same conclusion in *Reilly v. City and County of San Francisco, supra*. In *Reilly*, the court analyzed the change in ownership consequences of property held in trust where the trustor created successive lifetime beneficiaries who each received an interest in the net income of certain California real property. (*Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4th 480.) The Court of Appeal concluded that a change in the trust's lifetime beneficiary constituted a change in ownership of all the real property held by the trust. In reaching that conclusion, the *Reilly* court applied subdivision (a) of Rule 462.060 to find that "a life estate in real property is an interest equivalent in value to the fee interest." (*Reilly, supra*, at pp. 495-96.) Thus, consistent with *Leckie*, the appellate court concluded that a change in the lifetime beneficiary of real property is a change in ownership of that property, unless that interest is reserved for the transferor or the transferor's spouse.

II. Discussion of Petition

The petition requests that the Board amend Rule 462.060, as shown below in strike out and underlined text:

(a) Life estates. The creation of a life estate in real property is a change in ownership at the time of transfer unless the instrument creating the life estate reserves such estate in the transferor or the transferor's spouse. ~~However, the subsequent transfer of such a life estate by the transferor or the transferor's spouse to a third party is a change in ownership.~~ Upon termination of such a reserved life estate, the vesting of a right to possession or enjoyment of a remainderman (other than the transferor or the transferor's spouse) is a change in ownership. The creation of a life estate in real property for the benefit of a life tenant other than the transferor or his or her spouse is not a change in ownership unless the written instrument, whether recorded or not, creating the life estate:

(1) provides the life tenant a legally enforceable present interest in the entire real property,

(2) provides the life tenant the full and exclusive beneficial use of the entire real property for his or her lifetime, and

(3) the value of the legal and beneficial interest transferred to the life tenant is substantially equal to the value of the fee interest of the entire real property. The value of the interest transferred to the life tenant is determined as follows:

(A) If the life tenant purchased his or her lifetime interest in the real property, the value of the purchased interest is the purchase price paid in the transaction unless it is established by a preponderance of the evidence that the interest would not have transferred for that purchase price in an open market transaction. The purchase price of the life tenant's interest shall be rebuttably presumed to be the full cash value of that interest if the terms of the transaction were negotiated at arms length between a knowledgeable transferor and life tenant neither of which could take advantage of the exigencies of the other.

(B) If the life estate in real property is gratuitously created, or in any case where the transferor and the life tenant did not, or could not, negotiate at arms length, the value of the transferred interest is the amount the transferor would report, whether or not he or she did report, to the Internal Revenue Service as a taxable gift, disregarding the consideration, if any, paid by the life tenant in the transaction.

(b) Estate for years. The creation of an estate for years for a term of 35 years or more in real property is a change in ownership at the time of transfer unless the instrument creating the estate for years reserves such estate in the transferor or the transferor's spouse. However, the subsequent transfer of such an estate for years by the transferor or the transferor's spouse to a third party is a change in ownership. Upon the termination of a reserved estate for years for any term, the vesting of the right to possession or enjoyment of a remainderman (other than the transferor or the transferor's spouse) is a change in ownership. The creation or transfer of an estate for years for less than 35 years is not a change in ownership.

(c) For purposes of this Rule, "real property" means that appraisal unit that persons in the marketplace commonly buy and sell as a unit.

Mr. Bennett states in his petition that Rule 462.060 should be amended as indicated above because the creation of a life estate may not meet the three-part change in ownership test established by section 60 of the Revenue and Taxation Code. Specifically, Mr. Bennett contends that "the existing Rule is poorly worded and confusing and should be amended and restated to completely harmonize with Revenue & Taxation Code Section 60 and other R&T sections." Thus, Mr. Bennett proposes to establish that the creation of a life estate is not a change in ownership unless the life tenant obtains (a) a legally enforceable present interest in the entire real property, (b) including full and exclusive use of that entire property, and (c) a value substantially equal to the value of the fee interest.

To illustrate, Adam (A) dies leaving a life estate in real property to Barbara (B), an individual unrelated to A, and a remainder interest to Carole (C), A's only child. B is 75 years old on the date of A's death and has a remaining life expectancy of 10 years. Under current law, the creation of B's life estate constitutes a change in ownership unless B otherwise qualifies for an exclusion (for purposes of this illustration, we assume that B does not qualify for any other exclusion). This change in ownership results without giving any consideration to the nature of the interests, beneficial use, or value of the life estate received by the life tenant.

If the Board grants this petition, then, given the facts set forth in the above illustration, the county assessor would be required to perform three separate tests to determine whether the creation of B's life estate on the date of A's death is a change in ownership. Under the proposed amendment, no change in ownership would occur if the county assessor determines that any one of those three tests is not met; county assessors would be required to apply all three tests on a case-by-case analysis upon the creation of every life estate in California real property.

A. Present Interest Test

As described above, the grant of a life estate—or any other interest in real property—must meet the three-part test of Revenue and Taxation Code section 60 to result in a change in ownership. Subdivision (a)(1) of the proposed amendment expands on that definition to require that the life tenant obtain a “legally enforceable present interest in the entire real property.”

By adding the phrase “in the entire real property” petitioner requests that the Board narrow the section 60 change in ownership definition in the context of life estates. In subdivision (c) of the proposed amendment, petitioner defines “real property” to mean “appraisal unit.” Ostensibly, petitioner seeks to limit changes in ownership to those occasions when a life tenant obtains a present interest in an entire appraisal unit. Such a requirement is found in no other area of change in ownership law. While an appraisal unit defines the unit of real property to be appraised for assessment purposes, that concept has not been previously applied to determine whether or not a change in ownership has occurred. (See the discussion of “appraisal unit” in Assessors’ Handbook Section 501, *Basic Appraisal*, pp. 10-11.)

B. Full and Exclusive Beneficial Use Test

In subdivision (a)(2) of the proposed amendment, petitioner has restated and expanded on the “beneficial use” element of the section 60 change in ownership definition. Petitioner seeks to exclude the creation of life estates from change in ownership if the life tenant does not obtain “full and exclusive beneficial use of the entire real property for his or her lifetime.”

By requiring that the life tenant acquire “exclusive use” of the real property, this proposed amendment will impose a test that does not apply to grants of other fee interests in real property. Creation of tenancies in common and joint tenancies are changes in ownership notwithstanding the fact that the tenants in common and joint tenants must share use of the real property with the other owners. (Rev. & Tax. Code, § 61, subs. (e) & (f).) Although an “exclusive use” test exists in the assessment of taxable possessory interests, it has not been applied to the change in ownership treatment of life estates or any other fee interests in real property. (See Rev. & Tax. Code, § 107 and Property Tax Rule 20.)

To the extent that the grant of a lifetime income interest in real property may fail to give a life tenant “full and exclusive beneficial use of the entire real property”, the grant of such an interest will no longer result in a change in ownership. Life estates are often conveyed through trusts, and a lifetime interest in income from trust property has historically been referred to as an “equitable life estate.” (*Reilly v. City and County of San Francisco, supra.*, citing *Estate of LeFranc* (1952) 38 Cal.2d 289, 295 & fn. 1; *Estate of McCurdy* (1925) 197 Cal. 276, 286 and *Estate of High* (1967) 250 Cal.App.2d 561, 562-563, 567.) However, California courts have recognized that changes in ownership occur upon the vesting of an “equitable life estate” in real property. (See *Reilly, supra.*, at pp. 495-96.) If the creation of an equitable life estate does not confer “full and exclusive beneficial use” of the real property, this proposed amendment will exclude that “equitable life estate” from change in ownership treatment.

C. Value Equivalence Test

In this regard, Mr. Bennett's current petition restates and expands on his previous petition heard by the Board at its meeting on April 25. If the Board grants this petition, then, given the facts set forth in the above illustration, the county assessor would be required to determine whether the value of B's life estate on the date of A's death is substantially equal to the value of the fee interest in the real property. Under the proposed amendment, no change in ownership would occur if the county assessor determines that the estimated present value of B's life estate—as calculated under subdivisions (a)(3)(A) and (a)(3)(B) of the proposed amendment—is not “substantially equal to the value of the entire real property.” Again, county assessors would be required to apply this value test on a case-by-case analysis upon the creation of every life estate in California real property.

III. Staff's Recommendation

Staff recommends that the Board deny the petition because the current version of Rule 462.060 conforms both to the applicable statutes and recent published appellate court decisions. In staff's opinion, the change in ownership treatment of life estates is well-settled law. As discussed above, the Board's rule correctly interprets the plain language of sections 60 and 62, subdivision (e), and is consistent with the legislative intent indicated by the Task Force Report in determining that the life tenant is the primary owner under section 60. Thus, it is staff's opinion that Revenue and Taxation Code sections 60 and 62, subdivision (e) clearly contemplate the change in ownership treatment of life estates reflected in the Board's existing rule.

Furthermore, it is staff's opinion that, absent legislative change or an appellate court holding otherwise, the proposed amendments to Rule 462.060 to exclude the creation of certain life estates from change in ownership is beyond that the scope of the exclusion authorized by the Legislature in subdivision (e) of section 62, which only excludes the creation of life estates reserved for the transferor or the transferor's spouse. Therefore, staff recommends that the petition be denied.

IV. Conclusion

To summarize, staff recommends that the Board deny the petition to amend Rule 462.060, which proposes to create a new change in ownership exclusion for the creation of life estates based on the three tests described in the amendment. It is staff's opinion that Rule 462.060 conforms to the applicable statutory provisions and published appellate court decisions. Lastly, it is staff's opinion that amendments requested in the petition would require new legislation.

If you need more information or have any questions, please contact Acting Assistant Chief Counsel Robert Lambert at (916) 324-6593.

Approved: 

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KEC:ML:jh

Prop/Rules/Rule 462.060/0507/Amendment.doc
Chief Counsel/Final/Rule 462.060 Amendment.doc

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