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April 4, 2008

Re: *Change in Ownership – Reorganizations and Transfers of Shares in Corporations*
Assignment No.: 07-087

Dear Mr. :

This letter is in response to your letters to Acting Assistant Chief Counsel Robert Lambert dated March 5, 2007, and October 17, 2007. In those letters, you asked whether certain transfers of voting stock (hereinafter referred to as “shares”) in family-owned corporations would constitute a change in ownership under Revenue and Taxation Code¹ sections 60 et seq.

As explained in greater detail below, based on the facts you provided, we conclude that: (i) a spin-off would result in a change in ownership of the real property spun off (Alternative One); (ii) a split-up would result in a change in ownership of all real property (Alternative Two); and (iii) a drop-down of real property into newly formed, wholly owned subsidiaries would not result in a change in ownership (Alternative Three).

FACTS

Your letters provided the following facts:

1. X Corporation, a subchapter S corporation, is owned 50 percent each by two families. Husband X and wife Y (Family A) own 50 percent as community property; husband M and wife N, and husband O and wife P (all together, Family B) own the remaining 50 percent as follows: M and N, trustors, together own 25 percent via a family revocable trust, and O and P, trustors, together own 25 percent via a family revocable trust. For purposes of this opinion, we assume that, prior to the transfer of the shares to their respective revocable trusts, title to M and N’s interest was held solely in M’s name, and title to O and P’s interest was held solely in O’s name, even though such interests may be community property under California law.

¹ All further statutory references are to the Revenue and Taxation Code unless otherwise specified.

2. X Corporation owns 10-13 commercial properties.
3. Family A and Family B desire to separate their business interests. In 2006, the families entered into an agreement for an internal business restructuring.

In your March 5, 2007 letter, you presented two alternative, hypothetical transactions for purposes of splitting the properties between the families, herein “Alternative One” and “Alternative Two.” In addition, your October 17, 2007 letter poses a third possibility, herein “Alternative Three,” which has already been effectuated.

For purposes of this opinion, since we look through a trust to determine beneficial ownership for property tax purposes such that a trustor is considered to be the present beneficial owner of the trust corpus of a revocable trust, and since the transfers involving the trusts are not at issue, we will assume that M and O own their current respective interests outright and receive the proposed transfers in their individual capacities. (See Property Tax Rule 462.160.)

LAW & ANALYSIS

Section 60 defines a change in ownership as: (1) a transfer of a present interest in real property, (2) including the beneficial use thereof, (3) the value of which is substantially equal to the value of the fee interest.

In general, a transfer of any interest in real property between one corporation and another corporation or any other person results is a change in ownership under section 61, subdivision (j). Several relevant exceptions to this general rule are discussed below.

Under section 62, subdivision (a)(2), a transfer of real property between individuals and a corporation or between corporations “that results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees . . . represented by [voting] stock” is the same after the transfer, does not result in a change in ownership. If transfers of real property to a corporation excluded under this provision occur on or after March 1, 1975, after the transfers the shareholders of that corporation become “original co-owners.” (Section 64, subd. (d).) Then, whenever cumulatively more than 50 percent of the total voting shares in the corporation are transferred by any of the original co-owners in one or more transactions, a change in ownership occurs of the real property owned by that corporation that was previously excluded from reassessment under section 62, subdivision (a)(2). (Section 64, subd. (d).)

Additionally, section 64, subdivision (a) provides the general rule that the transfer of shares of a corporation is not a transfer of the corporation’s real property, and thus does not constitute a change in ownership.

Section 64, subdivision (b) also sets forth an exclusion from change in ownership of any corporate reorganization that qualifies under section 368 of the Internal Revenue Code of 1986, as amended (IRC) and is a nontaxable event under California law, but only if all corporations involved are “members of an affiliated group.” In addition, subdivision (b) excludes from change in ownership transfers of real property or legal entity ownership interests among members of an affiliated group. Subdivision (b) defines “affiliated group” as “one or more chains of corporations connected through stock ownership with a common parent corporation”

where both of the following conditions are met: (1) one hundred percent of the voting stock (exclusive of any share owned by directors) of each of the corporations (except the parent corporation) is owned by one or more of the other corporations; and (2) the common parent corporation owns, directly, 100 percent of the voting stock (exclusive of shares owned by the directors) of at least one of the other corporations. In *Pueblos Del Rio South v. City of San Diego* (1989) 209 Cal.App.3d 893, and *Sav-On Drugs, Inc. v. County of Orange* (1987) 190 Cal.App.3d 1611, the California Court of Appeal concluded the phrase “members of an affiliated group” means affiliation from the beginning of the transaction until the end of the transaction and that affiliation cannot be just one step in the reorganization.

Lastly, section 64, subdivision (c)(1) provides an exception to section 64, subdivision (a). It provides that when any legal entity or person obtains direct or indirect ownership or control of more than 50 percent of the voting stock of a corporation through a purchase or transfer, there is a change in ownership of the corporation’s real property. For purposes of section 64, subdivision (c)(1), a husband and wife’s community property ownership interests in an entity are not aggregated when testing for the more than 50 percent ownership or control. (See Rule 462.180, subd. (d)(2), example 7; back-up letter to Annotation 220.0091; and Annotation 220.0040.)

ALTERNATIVE ONE

Alternative One is a spin-off. X Corporation transfers 50 percent of its properties (determined by value) to newly formed Y Corporation, formed to effectuate the spin-off. Y Corporation issues all of its shares to X Corporation in return for the properties, and X Corporation immediately distributes all Y Corporation shares to Family B in exchange for their shares in X Corporation. As a result, Family B owns 100 percent of Y Corporation and Family A owns 100 percent of X Corporation. M and O (Family B) will each own 50 percent of the Y Corporation shares, and X and Y (Family A) will own 100 percent of the X Corporation shares as community property.

Alternative One would result in a change in ownership of all Y Corporation real property, but would not result in a change in ownership of any X Corporation real property.

When a transfer of real property in connection with a reorganization qualifying under IRC section 368 is involved, we first analyze the reorganization under section 64, subdivision (b), to see whether the entire transaction meets the exclusion to change in ownership provided there. If the reorganization, viewed in its entirety, fails to meet the requirements of section 64, subdivision (b), we analyze the component steps in the transaction to determine whether any individual step results in a change in ownership of the subject real property.

Alternative One does not qualify for the exclusion set forth in section 64, subdivision (b), even if the transaction qualifies as a reorganization under IRC section 368 as a tax-free spin-off under IRC section 355 and is a nontaxable event under California law. Under subdivision (b), all of the corporations involved in the reorganization must be members of an affiliated group. (Section 64, subd. (b).) This requires common parent corporate ownership of all parties to the reorganization both before and after the reorganization. (Section 64, subd. (b)(1)-(2); *Pueblos Del Rio South v. City of San Diego* 209 Cal.App.3d 893, and *Sav-On Drugs, Inc. v. County of Orange* 190 Cal.App.3d 1611.) After the spin-off, X and Y (Family A) will own X Corporation as community property, and M and O (Family B) will each own 50 percent of Y Corporation.

Since there will not be common parent corporate ownership of both X Corporation and Y Corporation after the spin-off, Y Corporation and X Corporation will not be part of an “affiliated group.” Because the end result of the reorganization is that X Corporation transferred to Y Corporation its entire interest in the subject properties and all ties between X Corporation and its formerly wholly owned subsidiary Y Corporation are severed, section 64, subdivision (b) is inapplicable. (See *Pueblos Del Rio South* 209 Cal.App.3d at 899.)

Since the reorganization set forth in Alternative One fails to meet the section 64, subdivision (b) exclusion to change in ownership, we analyze the component steps in the transaction to determine whether any of the steps results in a change in ownership.

First, the transfer by X Corporation of 50 percent of its real property to Y Corporation, in exchange for all of the Y Corporation shares, will not result in a change in ownership of the property. Section 62, subdivision (a)(2) excludes from change in ownership the transfer of real property from a parent corporation to its newly formed, wholly owned subsidiary. Under section 64, subdivision (d), X Corporation will become an “original co-owner” of Y Corporation shares. This transfer does not qualify for exclusion under section 64, subdivision (b) as a transfer among members of an affiliated group because Y Corporation and X Corporation were not affiliated prior to the transfer.

Thereafter, the transfer by X Corporation of all of the Y Corporation shares to Family B will result in a change in ownership of all of the Y Corporation real property, which was previously excluded from change in ownership under section 62, subdivision (a)(2). Because X Corporation is an “original co-owner” with respect to Y Corporation shares, the transfer by X Corporation of more than 50 percent of the Y Corporation shares results in a change in ownership under section 64, subdivision (d).

The redemption by Family B (M and O) of their shares in X Corporation does not result in a change in ownership of any of the X Corporation real property. After the redemption, X and Y (Family A) would own the X Corporation shares as community property. Their respective interests are not aggregated when testing for the more than 50 percent ownership or control under section 64, subdivision (c)(1). (See Rule 462.180, subd. (d)(2), example 7; back-up letter to Annotation 220.0091; and Annotation 220.0040.) Therefore, after M and O redeem their X Corporation shares, X and Y will each own exactly 50 percent of the X Corporation shares and neither will have obtained ownership or control of more than 50 percent. Since section 64, subdivision (c)(1) is inapplicable here, there is no change in ownership under section 64, subdivision (a).

ALTERNATIVE TWO

Alternative Two is a split-up. X Corporation transfers 50 percent of its real property (determined by value) to newly formed Y Corporation and 50 percent of its real property (determined by value) to newly formed Z Corporation, solely in exchange for the shares of each. Both Y Corporation and Z Corporation are formed to effectuate the split-up. X Corporation then distributes the Y Corporation shares to Family B and Z Corporation shares to Family A, each in exchange for their shares of X Corporation, after which X Corporation would liquidate. As a result, M and O (Family B) would each own 50 percent of the Y Corporation shares, and X and Y would own 100 percent of the Z Corporation shares as community property.

Alternative Two would result in a change in ownership of all Y Corporation real property and all Z Corporation real property.

As with our analysis of Alternative One, we first analyze the reorganization under section 64, subdivision (b), to see whether the entire transaction meets the exclusion to change in ownership provided there.

Alternative Two does not qualify for the exclusion set forth in section 64, subdivision (b), even if the transaction qualifies as a reorganization under IRC section 368 as a tax-free split-up, and is a nontaxable event under California law. Under subdivision (b), all of the corporations involved in the reorganization must be members of an affiliated group. (Section 64, subd. (b).) This requires common parent corporate ownership of all parties to the reorganization both before and after the reorganization. (Section 64, subd. (b)(1)-(2); *Pueblos Del Rio South v. City of San Diego* 209 Cal.App.3d 893, and *Sav-On Drugs, Inc. v. County of Orange* 190 Cal.App.3d 1611.) After the split-up, X Corporation is dissolved, so we measure affiliation by testing the relationship between Y Corporation and Z Corporation. After X Corporation capitalizes Y Corporation and Z Corporation by transferring its properties to them in exchange for all of their respective shares of voting stock, there is momentary affiliation between Y Corporation and Z Corporation. However, after the reorganization, X and Y (Family A) will own Z Corporation as community property, and M and O (Family B) will each own 50 percent of Y Corporation. Since there is no common parent corporate ownership of Y Corporation and Z Corporation after the reorganization, and the momentary common parent corporate ownership is just one step in the reorganization, Y Corporation and Z Corporation are not members of an affiliated group for purposes of section 64, subdivision (b).

Since Alternative Two, viewed in its entirety, fails to meet the requirements of section 64, subdivision (b), we analyze the component steps in the transaction to determine whether any of the steps results in a change in ownership.

First, the transfer by X Corporation of 50 percent of its real property to Y Corporation, in exchange for all of the Y Corporation shares, will not result in a change in ownership of the property. In addition, the transfer by X Corporation of the other 50 percent of its real property to Z Corporation, in exchange for all of the Z Corporation shares, similarly will not result in a change in ownership of the property. Section 62, subdivision (a)(2) excludes from change in ownership the transfer of real property from a parent corporation to its newly formed, wholly owned subsidiary. Under section 64, subdivision (d), however, X Corporation will become an "original co-owner" with respect to both the Y Corporation and the Z Corporation shares. These transfers do not qualify for exclusion under section 64, subdivision (b) as transfers among members of an affiliated group because Y Corporation and Z Corporation were not affiliated with X Corporation prior to the transfers.

The transfers by X Corporation of the Y Corporation shares to Family B and the Z Corporation shares to Family A, however, result in a change in ownership of all Y Corporation and Z Corporation real property. Because X Corporation is an "original co-owner" with respect to all Y Corporation and Z Corporations shares, the transfers by X Corporation of more than 50 percent of the Y Corporation and Z Corporation shares result in a change in ownership under section 64, subdivision (d) of all real property, which was previously excluded from reassessment under section 62, subdivision (a)(2).

ALTERNATIVE THREE

Alternative Three is a drop-down of assets into a new subsidiary. X Corporation transfers 50 percent of its real property (determined by value) to a newly formed, wholly owned subsidiary, Y Corporation, and the other 50 percent to another newly formed, wholly owned subsidiary, Z Corporation. Each subsidiary operates its subject properties independently and X Corporation remains the parent corporation of each.

Alternative Three would not result in a change in ownership of any Y Corporation or Z Corporation real property.

Both transfers by X Corporation will not result in a change in ownership of the property. Section 62, subdivision (a)(2) excludes from change in ownership the transfer of real property from a parent corporation to its newly formed, wholly owned subsidiary. However, under section 64, subdivision (d), X Corporation will become an "original co-owner" with respect to the Y Corporation and Z Corporation shares. As stated above under the Alternative Two discussion, these transfers do not qualify for exclusion under section 64, subdivision (b) as transfers among members of an affiliated group because Y Corporation and Z Corporation were not affiliated with X Corporation prior to the transfers.

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and are not binding on any person or public entity.

Sincerely,

/s/ Matthew Burke

Matthew Burke
Tax Counsel

MB:pb

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