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September 23, 2004

Re: Change in Ownership – Revenue and Property Tax Code section 64(a)

Dear Mr. :

This is in response to your May 14, 2004, letter to Ms. Kristine Cazadd, Assistant Chief Counsel, requesting our opinion as to whether a corporate reorganization involving a parent corporation, its primary shareholder, and its wholly-owned subsidiary will cause a change in ownership of the real property owned by the subsidiary. You suggest that the proposed reorganization will not result in a change in ownership of the real property of the wholly-owned subsidiary pursuant to Revenue and Taxation Code section 64, subdivision (a),[1] because no change in control of the subsidiary corporation occurs and thus subdivision (c) does not apply. For the reasons set forth below, we agree with your conclusion that the reorganization as described does not result in a change in ownership of the real property owned by the subsidiary.

Factual Background

B R , Inc., (BR) is the parent corporation of eleven wholly-owned subsidiary corporations, including B R P , Inc. (BRP) BRP owns commercial real property in Stanislaus County, which it rents to unrelated third parties, BR, and other BR subsidiaries. You do not indicate that BR owns any California real property, and in any event do not seek our opinion regarding any real property BR might own. The R Revocable Trust (Trust), a revocable inter vivos trust established by Wendell and Norma, owns approximately 51.06 percent of the outstanding voting stock, nonvoting stock, and total stock of BR. Gregory and Jeffrey each own approximately 24.21 percent of the outstanding voting stock, nonvoting stock, and total stock of BR. An irrevocable grandchildren's trust owns the remaining outstanding voting, nonvoting, and total stock of BR, or approximately 0.52 percent.

BR is considering a proposed corporate reorganization pursuant to Internal Revenue Code sections 355 and 368(a)(1)(D), commonly referred to as a "non-pro rata split off." In this type of reorganization, all the stock of BRP, currently held by BR, would be distributed to the Trust in exchange for 102,689 shares (12.8 percent) of nonvoting stock of BR held by the Trust. Following the proposed reorganization, the Trust would continue to own approximately 51.06 percent of the outstanding voting stock of BR, but its share of nonvoting stock would be reduced to approximately 42.93 percent and its share of the total outstanding stock reduced to approximately 43.86 percent. The Trust would also own 100 percent of all the outstanding stock of BRP. The other stockholders

[1] All section references are to the Revenue and Taxation Code unless stated otherwise.

of BR would not see a change in their share of the voting stock in BR, but would see small increases in their share of the nonvoting and total outstanding stock of BR due to the distribution to BR by the Trust of some of its shares of nonvoting stock in BR.

Applicable Law and Analysis

Section 64, subdivision (a), generally provides that the transfer of ownership interests in a legal entity, such as a corporation, does not constitute a transfer of the real property of the entity, and thus does not constitute a change in ownership of the real property of the entity. Section 64, subdivision (b), sets forth an exclusion from change in ownership of the real property of a corporation when the corporation is involved in a corporate reorganization qualifying under Internal Revenue Code section 368, is a nontaxable event under California law, and the corporations involved are members of an "affiliated group." Subdivision (b) defines "affiliated group" to "mean one or more chains of corporations connected through stock ownership with a common parent corporation" if (1) "One hundred percent of the voting stock . . . 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 . . . 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" in section 64, subdivision (b), 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.

Subdivision (c) of section 64 provides an exception to the general rule of subdivision (a) when a legal entity or person obtains direct or indirect ownership or control of more than 50 percent of the voting stock of a corporation, thus resulting in a change in ownership of the real property of the corporation. Section 64, subdivision (d), also provides an exception to the general rule of subdivision (a). Subdivision (d) provides that when real property is transferred to a legal entity and the transfer is excluded from change in ownership under section 62, subdivision (a)(2), the individuals holding interests in the legal entity immediately after the transfer will be "original co-owners." Subsequently, the transfer of cumulatively 50 percent or more of the voting stock in the entity by the original co-owners causes a change in ownership of the real property held by the entity and previously excluded from change in ownership under section 62, subdivision (a)(2).

Upon review of the reorganization set forth in your letter with the above rules in mind, we conclude section 64, subdivision (a), applies to the reorganization and excludes the real property of BRP from change in ownership upon the transfer of 100 percent of BRP stock from BR to the Trust. Although the corporate reorganization described in your letter apparently qualifies under Internal Revenue Code section 368, and presumably California law, the reorganization does not appear to qualify for the exclusion set forth in section 64, subdivision (b), because the BRP will not be part of the "affiliated group" both before and after the transaction. Before the transaction, BR and its subsidiaries meet both requirements for an "affiliated group": 1) One hundred percent of the voting stock of each of the corporations, except the parent (BR), is owned by one or more of the other corporations, in this case BR; and 2) the common parent (BR) owns, directly, 100 percent of the voting stock of at least one of the other corporations. After the transaction, however, 100 percent of the voting stock of BRP will no longer be owned by one of the other corporations, thus violating the first requirement of the definition of "affiliated group" with respect to BRP.

Subdivision (c) does not apply to cause a change in ownership because, although 100 percent of the stock (presumably including 100 percent of the voting stock) of BRP is transferred from BR to the Trust, the Trust is not considered a separate legal entity. The transfer of property to a revocable trust is not a change in ownership because the trustor/settlor remains the beneficial owner of the property through the trust. (Rev. & Tax. Code, § 62, subd. (d).) To determine whether a transfer of property or interests in a legal entity (voting stock) constitutes a change in ownership, it is necessary to "look through" the trust to the individual trustors/settlors. (Annot. No. 220.0375.020.) Wendell and Norma, husband and wife, through the Trust own more than 50 percent of the voting stock before and after the reorganization. However, Wendell and Norma's percentage interests in the voting stock are not aggregated, as each is treated as a separate shareholder under the non-attribution principle stated in Property Tax Rule 462.180, subsection (d)(2), Example 7. Therefore, even if Wendell and Norma together would acquire control of BR following the reorganization, the law presumes that community property principles apply and that each spouse owns only 50 percent. Thus, no change in control occurs due to the reorganization for purposes of subdivision (c).

Finally, section 64, subdivision (d), does not apply to cause a change in ownership of the real property of BRP. Even if BR was an "original co-owner" in BRP, the reorganization did not cause a transfer of cumulatively more than 50 percent of the voting stock of BRP because Wendell and Norma were the controlling shareholders of BR and the trustors/settlors of the Trust. Thus, subdivision (d) is not applicable.

In conclusion, we reiterate our conclusion that section 64, subdivision (a), applies to the corporate reorganization as described to exclude the real property owned by BRP from change in ownership upon the transfer of the stock of BRP.

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 the facts set forth herein, and are not binding on any person or public entity.

Sincerely,

/s/ Reed Schreiter

Reed Schreiter
Senior Tax Counsel

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cc: Ms. Kristine Cazadd, MIC:82
Mr. David Gau, MIC:63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Todd Gilman, MIC:70