220.0451

STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
50 N STREET, SACRAMENTO, CALIFORNIA
O BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
TELEPHONE (916) 323-7713
FAX (916)323-3387

JOHAN KLEHS
First District, Hayward

DEAN F. ANDAL
Second District, Stockton

ERNEST J. DRONENBURG, JR.
Third District, San Diego

BRAD SHERMAN
Fourth District, Los Angeles

KATHLEEN CONNELL
Controller, Sacramento

E. L. SORENSEN, JR.
Executive Director

October 30, 1996

Revised 9/29/97

In Re: **Change in Ownership - Exclusions for Partnership and Parent/Child Transfers to "GRATS" and "CLATS."**

Dear Ms. :

This is in response to your June 13,1996 letter to Mr. Lawrence Augusta, in which you request our opinion regarding the change in ownership consequences and applicable exclusions relative to three proposed transactions, the background for which is as follows:

A. Husband ("H") and Wife ("W") own income-producing properties, Parcels A, B, C, and X, in the name of their revocable trust, HW Revocable Trust (of which they are the settlors, trustees, and beneficiaries). H and W transferred an undivided 99% interest in the parcels from the HW Revocable Trust ("Trust") to themselves as community property.

B. The Trust and H and W then transferred the parcels to a family limited partnership, "HW Ltd.," in which H and W own 99% of the capital and profits interests as individuals and the Trust owns 1% as the general partner.

Three alternative transactions are proposed for estate planning purposes:

Proposed Transaction No.1

1. HW Revocable Trust, as general partner, will transfer Parcel X out of HW Ltd. to H and W as individuals (community

property). H and W will transfer undivided interests in Parcel X to their children, C1, C2, and C3, while retaining a 40% interest for themselves as individuals.

2. The five individuals ,H, W, C1, C2, and C3 will transfer their proportionate interests in Parcel X to a limited liability company, "Famco LLC," ("Famco") in exchange for proportionate interests in Famco.

3. H will assign one-half(50%)of his limited partnership interests (49.5% of capital and profits)in HW Ltd. to W, (equivalent to W receiving an additional 24.75%). W will transfer those interests to one or more Grantor Annuity Trusts (GRATs"), which are irrevocable by W and in which W will be the sole income beneficiary for the following 6 to 18 years. The remainder beneficiaries of the GRATs are the three children or their trusts.

4. W, then holding 49.5% of HW Ltd., will assign one-quarter (25%) of her limited partnership interests (12.38% of capital and profits) to H, who will in turn transfer those interests to one or more GRATs (irrevocable by H), in which H will be the sole income beneficiary for the following 3 to 9 years. The remainder beneficiaries of the GRATs are the three children or their trusts.

During and upon the expiration of the terms of the GRATs, H and W will retain more than 50% of the interests in HW Ltd.

Proposed Transaction No. 2

1. HW Revocable Trust, as general partner, will transfer Parcels C and A from HW Ltd. to H and W as community property.

2. H and W will transfer Parcels C and A to one or more Charitable Lead Annuity Trusts, "CLATs," in which the Charity will be the sole income beneficiary for the following 10 to 12 years. The remainder beneficiaries of the CLATs are C1, C2, and C3, and H and W will be the Trustees. The CLATs cannot be revoked by H and W.

Proposed Transaction No. 3

1. H and W will assign 40% of their limited partnership interests in HW Ltd. to one or more CLATs (irrevocable by H and W), in which the Charity will be the sole income beneficiary for the following 3 to 7 years, and the remainder beneficiaries will be C1, C2, and C3 or their

trusts. H and W will be the Trustees and will report all income payable to Charity on their personal tax returns.

Your questions are:

(1) Whether the trust exclusions under Section 62(d) includes transfers of interests in legal entities and takes precedence over the change in ownership provisions in Section 64(d);

(2) Whether the step transaction doctrine is applicable to any of the foregoing transactions given the fact that they are all "intrafamily" transfers.

The answer to the first question is a qualified "yes," and the answer to the second question is "no," for the reasons hereinafter explained. An analysis of each proposed transaction is provided thereafter.

Question 1: Whether Section 62(d) should take precedence over Section 64(d)?

Yes. Transfers of interests in legal entities by "original coowners" into revocable trusts, trustor-transferor beneficiary trusts, or trustor reversion trusts should not be "counted" for Section 64(d) purposes.

Change in Ownership Concepts

Revenue and Taxation Code Section 60 defines "change in ownership" as 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."

Within that definition are the provisions of Section 61 (f) and (i) which include as changes in ownership:

(f) Any vesting of the right to possession or enjoyment of a remainder or reversionary interest which occurs upon the termination of a life estate or other similar precedent property interest, except as provided in subdivision (d) of Section 62 and in Section 63.

* * *

(i) The transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner, or any other person.

The exception for transfers into trusts provided in Section 62(d) states that change in ownership shall not include:

> (d) Any transfer by the trustor, or by the trustor's spouse, or by both, into a trust for so long as (1) the transferor is the present beneficiary of the trust, or (2) the trust is revocable; or any transfer by a trustee of such a trust described in either clause (1) or (2) back to the trustor; or, any creation or termination of a trust in which the trustor retains the reversion and in which the interest of others does not exceed 12 years duration.

Rule 462.160, which interprets Section 62(d), expressly states in (b)(2) that the **transfer of legal entity interests into a trust** is **not** a change in ownership, as long as the trustors-transferors are or will be the sole present beneficiaries of the trust, or the trust is revocable. Rule 462.160(b)(2) states as follows:

> "(b) Exceptions. A transfer to a trust is not a change in ownership upon the creation of or transfer to a trust if:
>
> * * *
>
> (2) Revocable Trusts. The transfer of real property or an ownership interest(s) in a legal entity by the trustor(s) to a trust which is revocable by the trustor(s); provided, however, a change in ownership does occur at the time the revocable trust becomes irrevocable unless the trustor-transferor remains or becomes the sole present beneficiary.

Based upon the foregoing statement in the rule, transfers of interests in legal entities into trusts that are otherwise excludable under Section 62(d), are excluded from change in ownership, as well as transfers of real property. The last part of the sentence in (b)(2) specifically excludes transfers of real property or legal entity interests to **irrevocable** trusts where "the trustor-transferor **remains**...the sole present beneficiary" (i.e, trustor-transferor beneficiary trusts per Section 62(d) and Rule 462.160(b)(1)), and trusts where "the trustor-transferor **becomes**...the sole present beneficiary" (i.e., trustor-reversion trusts, per Section 62(d) and Rule 462.160(b)(3), where there is a temporary shift in the beneficial ownership for a term of less than 12 years, after which time the trustor who holds the reversion again "becomes" the owner). Thus, the language in subdivision (b)(2) covers transfers of legal entity interests into the same three trusts excludable under Section 62(d). (See also Shedd Letter, May 18, 1981, p.2, copy enclosed.)

The issue raised here is whether transfers by "**original coowners**" of legal entity interests into trusts are also excluded from change in ownership based on the same provisions.

"Original Coowner" Status

"Original coowner" status derives its source from one's prior utilization of the exclusion for transfers into legal entities set forth in Section 62(a)(2). That exclusion states that a change in ownership shall not include:

> Any transfer between an individual or individuals and a legal entity or between legal entities, such as a cotenancy to a partnership, a partnership to a corporation, or a trust to a cotenancy, which results solely in a change in the method of holding title to the real property and in which the proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interests, or otherwise, in each and every piece of real property transferred, remain the same after the transfer. The provisions of this paragraph shall not apply to transfers also excluded from change in ownership under the provisions of subdivision (b) of Section 64.

The interpretation of Section 62(a)(2) under Rule 462.180(b)(2) defines transferors who utilize Section 62(a)(2) as "original co-owners." Rule 462.180(b)(2) states as follows:

[Excluded from the change in ownership provisions are] transfers of real property between separate legal entities or by an individual(s) to a legal entity (or vice versa), which result solely in a change in the method of holding title and in which the proportional ownership interests in the property remain the same after the transfer. (The holders of the ownership interests in the transferee legal entity, whether such interests are represented by stock, partnership shares, or other types of ownership interests, shall be defined as "original co-owners" for purposes of determining whether a change in ownership has occurred upon the subsequent transfer(s) of the ownership interests in the legal entity.

Section 64(d) governs transfers of interests in legal entities made by "original coowners" and states the following:

> If property is transferred on or after March 1, 1975, to a legal entity in a transaction excluded from change in ownership by paragraph (2) of subdivision (a) of Section 62, then the persons holding ownership interests in that legal

entity immediately after the transfer shall be considered the "original co-owners." Whenever shares or other ownership interests representing cumulatively **more than 50 percent of the total interests** in the entity are **transferred** by any of the **original co-owners** in one or more property transactions, a change in ownership of that real property owned by the legal entity shall have occurred, and the property that was previously excluded from change in ownership under the provisions of Section 62(a)(2) shall be reappraised. The date of reappraisal shall be the date of the transfer of the ownership interest representing individually or cumulatively more than 50 percent of the interests in the entity.

Rule 462.180(d)(2) is the pertinent rule provision which interprets Section 64(d)and explains how and when it is to be applied:

(d) EXCEPTIONS.

* * *

(2) When real property transferred to a corporation, partnership or other legal entity is excluded from a change in ownership pursuant to (b)(2) and the "original co-owners" subsequently transfer in one or more transactions, more than 50 percent of the total control or ownership interests in the entity as defined in (d)(1). For purposes of determining whether more than 50 percent of the total control or ownership interests in the entity has been transferred, <u>transfers of such interests by the "original co-owners" shall be cumulated beginning with the time of the first ownership interest transfer</u>. (<u>Emphasis added</u>.)

Based on the foregoing, if <u>**any**</u> transfer of interests in a legal entity by the "original coowners" must be "cumulated" or **counted** as a "transfer" for purposes of Section 64(d), then cumulative "transfers" by original coowners of more than 50 percent of the total interests in a partnership <u>**into a trust**</u> would cause the real property previously excluded from change in ownership by Section 62(a)(2), to be removed from the benefits of the exclusion and undergo reassessment.

In the hypothetical submitted, the first transfer by H and W of an undivided 99% interest in the four parcels from HW Revocable Trust to themselves as individuals with HW Revocable Trust retaining 1%, was excluded from change in ownership per Section 62(d), rather than under Section 62(a)(2), since the transfer was to the transferors, the present beneficiaries of the

Trust, and the Trust was revocable. However, the second transfer of the four parcels by H and W and HW Revocable Trust to the limited partnership (HW Ltd.) was excluded from change in ownership under Section 62(a)(2), because the interests in the property were held by H and W and HW Revocable Trust in HW Ltd. in the same proportionate shares before and after the transfer. Since the second transfer was excluded under Section 62(a)(2), H and W and HW Revocable Trust acquired "original coowner" status for purposes of making subsequent transfers of their partnership interests in HW Ltd. In some of the subsequent proposed transactions, H and W will be transferring (assigning) a portion of their limited partnership interests as "original coowners" in HW Ltd. to various types of trusts.

We have advised in previous opinion letters, as you point out, that transfers of partnership interests into trusts by "original coowners" could be "**counted**" for change in ownership purposes under Section 64(d). The reason for such advice lies in the rather broad language used in Section 64(d) dealing with transfers by original coowners. We stated that there are no specific statutory or regulatory provisions which define or limit the term "transferred", as it is used in Section 64(d). Further, we are aware of no court cases which have clearly construed the term. Thus, if the term "transferred" is applied literally and given its broadest scope, then every transfer of an ownership interest in a legal entity would be included.

On the other hand, compelling arguments can be made for excluding certain types of transfers of ownership interests from the operation of Section 64(d), particularly those transfers which would otherwise have been excluded from change in ownership had interests in the real properties instead been transferred. For example, the transfer of more than 50% of a legal entity's interests into trusts should not be considered for Section 64(d) purposes, because the partners/shareholders are already the beneficial owners of those interests and the transfer of only bare legal title is involved. (See Section 62(a)(2); also Parkmerced Co. v. City and County of San Francisco (1983) 149 Cal.App.3d 191; Allen v. Sutter County Board of Equalization (1983) 138 Cal.App.3d 887.) Thus, there is no policy reason why a change in ownership should be invoked merely because transferors are "original coowners" who transfer more than 50% of the partnership interests into their trusts.

However, we cautioned taxpayers that while such arguments appear to be logically consistent with the change in ownership provisions expressed in the law insofar as transfers of real property interests are concerned, Section 64(d) deals with **transfers of ownership interests in legal entities.** Therefore,

even though the narrower construction reflects the general change in ownership concepts, we found no authority which mandates this narrower approach to the term. Until the term is clarified either through legislation or court construction, we advised that **it is possible** for assessors to give the term "transferred" (in Section 64(d)) its broad, literal meaning and urged taxpayers to consult with the appropriate county assessor to determine the county's approach on this matter.

You have requested that we revisit this issue and approach it from the standpoint that the trust exclusion in Section 62(d) "takes precedence" over the Section 64(d) exception, thereby permitting assessors to exclude transfers of legal entity interests into trusts by original coowners for Section 64(d) purposes. In response to your request, we have researched the legislative history of Section 62(d) and have reconsidered the language in Rule 462.160.

Based on our research and review, it now appears that a transfer by "original coowners" into a trust which would otherwise be excluded from change in ownership under Section 62(d) or Rule 462.160(b)(2) should **not be "counted"** or considered for Section 64(d) purposes.

Legislative History and Findings Re Section 62(d), Section 64(d).

First, Section 62(d) provides for the exclusion of transfers of legal entity interests into revocable trusts and irrevocable trusts where the trustor-transferor remains or becomes the beneficiary, **regardless** of whether the trustor-transferor previously utilized the Section 62(a)(2) exclusion. The language of Section 62(d) **expressly** includes "**Any transfer** by the trustor...into a trust...". The reason for this language is that in all three types of trusts described, the trustor's **present interest** in the trust property has **not transferred**, but remains in the trustor-transferor, "substantially equivalent in value to the fee interest." The language intentionally reflects the contemporaneous construction by the Legislature in Section 60 that there is no "change in ownership" where there is no transfer of a present interest in real property.

The recommendation of the Assembly Revenue and Taxation Committee Task Force to the Legislature regarding Section 62(d) was to follow the approach that would maintain consistency with the definition of change in ownership in Proposition 13. That recommendation is explained as follows:

> "Revocable living trusts are merely a substitute for a will. The gifts over to persons other than the trustor are

contingent; the trust can be revoked or those beneficiaries may predecease the trustor. Transfers into trust are not changes in ownership if either:

(a) The trust is revocable, or;
(b) The creator of the trust is its sole beneficiary during his lifetime.

"If the trust is revocable, it is excluded because the rights conferred are contingent. If the trustor is the sole beneficiary during his lifetime, his retained interest is considered to be 'substantially equivalent in value' to the fee interest in any real property conferred by the trust. He is therefore the true owner and the change in ownership does not occur until the property passes to the remaindermen on the trustor's death." (See Report of the Task Force on Property Tax Administration, January 22, 1979, p.43.)

For the same reason, transfers into irrevocable trusts with a term of less than 12 years ("Clifford Trusts") were later added to the foregoing list, since the trust property reverts back to the trustor at the expiration of 12 years, thereby avoiding any permanent shift in the present beneficial ownership.

The language excluding "**any transfers**" into the described trusts was adopted without specifying the character of the property transferred (real property or interests in legal entities), until the rule was adopted. The history of Section 62(d) suggests that the Legislature never intended the exclusion for trusts to apply **only** to transfers of real property into trusts. If that had been the case, there would have been a need for two exclusions instead of one. Instructions to the assessors would have been necessary, directing them to split the ownership interests in trust between real property and legal entities and to determine which exclusion might be applicable. Alternatively, assessors would have been advised to deny the exclusion whenever shares or partnership interests were transferred into trust. Discussion found in the Task Force Report and other contemporaneous documents suggest that the antithesis was true.

Secondly, the Board staff saw no conflict between Sections 62(d) and 64 at the time those provisions were being drafted. In staff's view, **any transfers** by a trustor into a trust, including transfers of interests in a legal entity, were to be excluded under Section 62(d), as long as the trustor-transferor owned the present beneficial interest. A change in ownership (or control) of any interests in a trust occurs **only** when someone other than the trustor-transferor receives the beneficial ownership of the

trust property. This view was expressed by the Board's staff shortly after the enactment of Section 62(d):

> "In our view, there is only one change in ownership for property transferred in trust, either upon transfer into trust or upon distribution to the beneficiaries. The only way one can rationalize the result mandated by Section 62(d) is to view either the trustor (when there is no change in ownership) or the equitable beneficiaries (when there is a change in ownership) as the owners of the property." (Milam Letter, July 18, 1980, copy enclosed.)

During the drafting of Rule 462 where both exclusions, Section 62(d) and Section 64, were under consideration, the staff responded in a similar manner to a letter questioning whether transfers of legal entity interests into trusts were excludable per Section 62(d). The example posited in the letter from Kenneth Leventhal & Company, March 12, 1981, described a situation where there was an apparent conflict between the Section 62(d) exclusion and the Section 64(c) change in control provision. "A" owned a majority interest in partnership, which he transferred to Revocable Trust, causing the trust beneficiary to receive "control" of the partnership. The letter speculated that the transfer should be excluded under Section 62(d) as a transfer to a revocable trust, but Section 64(c) required a change in control when more than 50% of the interests in a legal entity are acquired by any other person or entity. The question implied was whether the Section 62(d) exclusion would take precedence over the Section 64(c) exception.

In response, the Board staff concluded that Rule 462(i)(2)(B) [currently 462.160(b)(2)] provides that the "transfer of a controlling interest in a corporation or a majority interest in a partnership or other legal entity **to a revocable trust** does **not** constitute a change in ownership of the legal entity's property," and quoted the proposed language of subdivision (b)(2) of the rule. (Shedd Letter, May 18, 1981.) Knowledge of the Legislature's intent in Section 62(d) to exclude "**any** transfers" into the described trusts was also a supporting reason for this conclusion.

Thirdly, Section 62(d) must be interpreted in a manner that is consistent with Section 64(d). Thus, we are guided by the long-accepted principle that the general definition of "change in ownership" in Section 60 is "controlling in all cases where a more specific provision to the contrary is absent." (Rigby Letter, July 9, 1982, copy enclosed.) The Legislature enacted Sections 60, 62(d) and 64(d) simultaneously, including the language in 62(d) which unambiguously excludes "**any transfer by**

the trustor, or by the trustor's spouse, or by both" into the three trusts described. The Board adopted Rule 462.160(b)(2) two years later, as we have noted, implementing the exclusion with the express provision that "ownership interests in legal entities" were also excludable transfers into such trusts. The reasoning behind both provisions was that regardless of the trustor-transferor's status (as an "original coowner'), and regardless of the types of interests held in trust (real property or legal entity), there was no transfer of present beneficial ownership because the trustor's "retained interest is considered to be substantially equivalent in value to the fee interests in any real property covered by the trust." (See Report of the Task Force on Property Tax Administration, January 22, 1979, p.43, as to Section 62(d).)

If Section 62(d) were to be denied application to transfers by "original coowners" into trusts, the result could be numerous changes in ownership even though the present beneficial owners of the property (trust corpus) remained the same. Failure to exclude from consideration for change in ownership purposes the transfer of legal entity interests by "original coowners" into trusts triggers the unwarranted consequence of reappraising the real property of "original coowners" when there is no transfer of a present beneficial ownership of the trust property. For example, assume A and B are original coowners and each own 50% of Corp.
A and B transfer 100% of Corp stock to a Trust for A, B, C and D, which is revocable by A and B (or in which A and B retain the reversion and Trust does not exceed 12 years). If the trust exclusion in Section 62(d) is **not** applied, Section 64(d) would require a change in ownership of the Corp real property, even though the trustors have not changed and continue to be the present beneficial owners of the Corp. Such a result would be contrary to the general definition of "change in ownership" per Section 60, since the trustor(s) continue to own the property and did not transfer a "present interest, including the beneficial use thereof, the value of which is substantially equivalent to the value of the fee interest."

There seems to be no legal or practical justification for denying the Section 62(d) exclusion to trustor/transferors who are classified as "original coowners" under Section 64(d). Refusal to allow the application of Section 62(d) in such cases effectively restricts it to the confines of original coowner provision in Section 64(d), a result which appears to be contrary to the legislative history and intent.

Question 2: Is the Step Transaction Doctrine Applicable to Parent/Child Transfers When the Transferors are Original Coowners?

No, if the transfers conform to examples in the legislative intent statement footnoted in Section 63.1.

Apart from the application of the parent-child exclusion, H and W's transfer of real property to their children constitutes a change in ownership of the property transferred (Section 61(e)). The only "intrafamily transfers" provided among the exclusions from change in ownership are found in Section 63.1. The parent-child exclusion applies to transfers of the first $1 million dollars in full cash value of **real property** between parents and their children, provided that in each case an "eligible transferor" transfers real property to an "eligible transferee." Per the statutory definitions, subdivision (a) of Section 63.1 provides in relevant part:

> (a) Notwithstanding any other provision of this chapter, a change in ownership shall not include either of the following purchases or transfers for which a claim is filed pursuant to this section:
>
> > (2) The purchase or transfer of the first one million dollars ($1,000,000) of full cash value of all other **real property** of an eligible transferor in the case of a purchase or transfer **between parents and their children.**
>
> (c) As used in this section:
>
> > (1) "Purchase or transfer between parents and their children" means **either a transfer from a parent or parents to a child or children of the parent or parents or a transfer from a child or children to a parent or parents of the child or children.**

Based on the foregoing, transfers of interests in a partnership or other legal entity are not eligible for the parent/child exclusion. Similarly, transfers of real property from a partnership or other legal entity do not qualify as transfers from a parent ("eligible transferor") to a child. However, where as here, a series of steps are taken (per the Section 63.1 statement of intent) so that the children will receive from their parents **interests in real property**, rather than interests in a partnership, and the eligible **transferors** of the real property at the time are the parents, **not** the

partnership, then the transfers of interests in real property to the children, could qualify for the parent-child exclusion, if a claim is timely filed and if the step transaction doctrine is not applied.

The "step transaction doctrine" has been applied to property tax transfers when unnecessary steps are taken merely to circumvent the intent of the change in ownership statutes; in which case, the "substance of the transaction, rather than the form" will determine if a change in ownership has actually occurred. (Shuwa Investment Corp. v. County of Los Angeles (1991) 1 Cal. App. 4th 1635). The single statutory exception is the series of transfers described in the statement of legislative intent at the end of Section 63.1, which prevent the application of the step transaction doctrine to any transfer that is otherwise eligible for the parent-child exclusion.

In Proposed Transaction No.1, the transfers made before and during Step 1 are extra steps taken by H and W presumably to utilize the parent-child exclusion by removing the real property from the ownership of the legal entity, an ineligible transferor. As noted in Section 63.1 above, if the HW Ltd. partners transferred partnership interests, rather than interests in real property directly to C1, C2, and C3, then the exclusion under Section 63.1 would **not** be applicable. By transferring Parcel X from HW Ltd. to H and W first and then transferring to C1, C2, and C3 a 60% interest in Parcel X, (rather than the equivalent interest in HW Ltd.), H and W will have undertaken an **extra step**, thereby allowing C1, C2, and C3 the use of the parent-child exclusion.

Your primary concern is that regardless of the Section 63.1 legislative intent statement, the step transaction doctrine may be applicable because the partners in HW Ltd. are "original coowners" per Section 64(d). We addressed this concern last year in a question/answer format, briefly explaining that when parents, as transferors under Section 63.1 are also "original coowners" under Section 64(d), and they undertake transfers of real property which follow the series of steps described in the Section 63.1 statement of intent in order to utilize the parent/child exclusion, the step transaction doctrine does not apply to such transfers, and there is no change in ownership under Section 64(d). (See Cazadd Letter, March 15, 1996, p.3, copy enclosed.)

Because the series of steps described in the footnoted statement result in the transferors, "original coowners," transferring real property, rather than legal entity interests, to the children, the "original coowners" have not triggered the

application of Section 64(d). Therefore, we believe that the parents' "original coowner" status does not change the results under Section 63.1, providing the examples described in the statement of intent are followed.

The legislative purpose underlying Section 63.1 with regard to the step transaction doctrine is addressed in Section 2 of Chapter 48 of the Statutes of 1987. Section 2 explains the Legislature's intent for liberal construction, and **how** that construction should be applied through specific examples. The following quoted language, extends the exclusion to situations where parents and children undertake the described steps:

> "... it is the intent of the Legislature that the provisions of Section 63.1 of the Revenue and Taxation Code shall be liberally construed in order to carry out the intent of Proposition 58 on the November 4, 1986, general election ballot to exclude from change in ownership purchases or transfers between parents and their children described therein. Specifically, transfers of real property from a corporation, partnership...to an eligible transferor or transferors, where the latter are the **sole** beneficial owner or owners of the property, shall be fully recognized and shall not be ignored or given less than full recognition under a substance-over-form or step transaction doctrine, where the **sole** purpose of the transfer is to permit an immediate retransfer from an eligible transferor or transferors to an eligible transferee or transferees which qualifies for the exclusion from change in ownership provided by Section 63.1. Further, transfers of real property between eligible transferors and eligible transferees shall also be fully recognized when the transfers are immediately followed by a transfer from the eligible transferee or eligible transferees to a corporation, partnership, trust, or other legal entity where the transferee or transferees are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property, if the transfer between eligible transferors and eligible transferees satisfies the requirements of Section 63.1. Except as provided herein, nothing in this section shall be construed as an expression of intent on the part of the Legislature disapproving in principle the appropriate application of the substance-over-form or step-transaction doctrine. (Emphasis added.)

Based on the foregoing, it has been our position that an exception to the step transaction doctrine occurs **only** where the transfers (taking advantage of the parent-child exclusion) are **consistent** with the intent statement and **parallel** the examples.

The examples describe situations where the interests being transferred are interests in **real property**, and do not address whether the owners of a partnership are "original coowners." The reason for this is that the statement expressly allows for a series of steps whereby partnership **real property** is transferred to parents or children, and a change in ownership under Section 64(d) is **not** triggered by the transfers of real property.

We have stated however, that the use of the parent/child exclusion by means of the steps described in the statement of intent will, at the conclusion of the transaction place each partner in "original coowner" status. Thus, a change in ownership may be triggered by the parents/children in the newly formed or reconstituted legal entity, e.g, parents and children who are partners in the newly formed partnership are "original coowners" with respect to transfers made by that new partnership which could trigger a change in ownership if more than 50% of the total partnership interests were transferred. Consistent with our conclusion in response to Question 1, the transfers by these "original coowners" into any of the three trusts excluded in Section 62(d), would not be counted for change in ownership purposes under Section 64(d).

Analysis of Change in Ownership Consequences of Proposed Transactions.

1. Proposed Transaction No. 1 - excluded from change in ownership, Section 63.1.

Steps 1 and 2

In the first two steps of Proposed Transaction No.1, H W Ltd. will accomplish the following:

- Transfer Parcel X to H and W as individuals (title in community property);
- H and W transfer undivided interests in Parcel X to C1, C2, and C3 and retain 40% interest for themselves;
- H, W, C1, C2, C3 each transfer their interests in Parcel X to Famco LLC for proportionate Famco LLC interests.

As discussed above regarding the step transaction doctrine, this pattern appears to conform to the suggested series of transfers set forth in the statement of legislative intent in Section 63.1. The **extra step** taken by H and W to effect the transfer of a 60% interest in Parcel X to C1, C2, and C3 allows the use of the parent-child exclusion and will not trigger the application of the step transaction doctrine.

The one difference, however, between the examples in the statement of intent and this proposal, is that H and W, as partners of HW Ltd., are "original coowners" at the outset of the transfers prior to Step 1. The question, therefore, is whether any of the H and W transfers should be "counted" for purposes of Section 64(d). As indicated by the previous discussion, the answer to this question is "no." In accordance with the statement of intent the interests being transferred to the children are real property interests.

"Counting" the transfers made by "original coowners" for Section 64(d) purposes, requires that the transfers constitute "ownership interests in that legal entity" which previously benefited from an exclusion from change in ownership under Section 62(a)(2). H and W are transferring interests in real property (Parcel X), per the intent language in Section 63.1. Then HW Ltd. transfers to H and W proportionate real property interests (Parcel X) to be distributed to their children under the parent/child exclusion, after which H, W, and children retransfer to another entity composed of H and W and children. Thus, H and W are not transferring legal entity interests required to be "counted" per Section 64(d). At the conclusion of the transaction, when H, W, and children are "original coowners" of Famco LLC, any subsequent transfers of its interests would be counted under Section 64(d).

Steps 3 and 4

H and W propose to transfer a portion of their respective limited partnership interests to each other, after which each will then transfer those interests into separate GRATs. As we understand it, a GRAT is a "Grantor Retained Annuity Trust" into which the grantor transfers property for the benefit of a remainder beneficiary who is a family member. The trust income which is retained by the grantor for a specified term consists of the right to receive periodic fixed amounts from the trust. (Internal Revenue Code Sec. 2702.) From the property tax standpoint, such trusts (whether GRATs or MIGRATs) involve a transfer to an irrevocable trust, with the income therefrom reserved to the trustor or other beneficiary and with any remainder in the property at the termination of the income interest to designated family members as the remainder persons.

In Step 3, H will transfer half of his HW Ltd. limited partnership interests (24.75%) to W, and W will transfer the same 24.75% to one or more irrevocable GRATs, in which she will be the sole income beneficiary for 6 to 18 years and the remainder beneficiaries are C1, C2, C3, and H. This would be excluded from change in ownership on the following grounds.

First, the transfer from H to W is excludable as an interspousal transfer under Section 63. We have consistently advised that the language in Section 63, excluding "any interspousal transfer," is applicable to all transfers between spouses, including transfers of interests in legal entities which would otherwise be a change in control under Section 64(c). The only question is whether H's transfer to W should be "counted" for Section 64(d) purposes, since H is an "original coowner" as the result of his initial transfers to HW Ltd. under the Section 62(a)(2) exclusion. Although we have not directly expressed a position on this issue, we conclude that for similar reasons enucleated for the exclusion of interspousal transfers from change in control per Section 64(c), transfers of partnership interests between spouses should not be "counted" for purposes of determining a change in ownership under Section 64(d). (See Cazadd Letter, May 20, 1996.) To maintain statutory consistency with the language in Section 63 which states, "Notwithstanding any other provision in this chapter, a change in ownership shall not include any interspousal transfer,..." it seems clear that the intent of the Legislature is to give precedence to Section 63 over other change in ownership provisions, including Section 64(d). Assessors should apply Section 63 literally, giving the language its broadest scope, whereby **every transfer** between spouses, including the transfer of an ownership interest in a legal entity where one of the spouses is an "original coowner," would be excluded from change in ownership, and the interest transferred would not be counted for purposes of Section 64(d).

"Secondly, the transfer by W of her 24.75% interests in HW Ltd. to one or more irrevocable GRATs is excluded from change in ownership under both Section 62(d) and Section 64(a). Section 62(d) ~~not~~ is applicable, because the beneficial interests in the property transferred(limited partnership interests) ~~vest in persons (children) other than the trustor-transferor (or transferor's spouse) per Section 61(g)~~ are owned by W as the GRAT's present beneficiary and the trustor-transferor for the 6-to-18 year duration of the GRAT. The parent/child exclusion under Section 63.1 does not apply, since the property transferred constitutes ownership interests in legal entities, not real property.

"Section 64(a) is also applicable to exclude partnership interest transfers and sets forth the general principle that there is no change ownership resulting from the transfer of interests in legal entities subject to certain exceptions: ..."

Except as provided in subdivision (h) of Section 61 and subdivisions (c) and (d) of this section, the purchase or

> transfer of ownership interests in legal entities, such as corporate stock or partnership or limited liability company interests, shall not be deemed to constitute a transfer of the real property of the legal entity. This subdivision is applicable to the purchase or transfer of ownership interests in a partnership without regard to whether it is a continuing or a dissolved partnership.

Since W will transfer less than a 50% interest (24.75%) in HW Ltd. to the irrevocable GRATs which will vest in the children, the transfer does not fall within the provisions of either Section 64 (c) or (d) and is excluded under Section 64(a). No one will acquire more than a 50% interest resulting in a change in control under Section 64(c), and less than 50% of the total partnership interests in HW Ltd. are being transferred, avoiding a change in ownership under Section 64(d). Since W is an "original coowner" however, her 24.75% transfer would be "counted" for purposes of Section 64(d) and cumulated with subsequent original coowner transfers of HW Ltd. interests in determining whether there is a future change in ownership of the HW Ltd. property.

The Step 4 transfer by W of one-quarter of her HW Ltd. limited partnership interests (12.38%) to H is excludable as an interspousal transfer under Section 63. Again, the only question is whether W's transfer to H should be "counted" for Section 64(d) purposes, since W is an "original coowner" in HW Ltd. As discussed above, we would advise assessors to apply Section 63 literally, giving the language its broadest scope, whereby every transfer between spouses, including the transfer of an ownership interest in a legal entity where one of the spouses is an "original coowner," would be excluded from change in ownership, and the interests transferred would not be counted for purposes of Section 64(d).

The subsequent transfer by H of his 12.38% interests in HW Ltd. to one or more irrevocable GRATs in which he will be the sole income beneficiary for 3 to 9 years, (remainder beneficiaries will be C1, C2, and C3) would be excluded under Section 64(a), **not** Section 62(d). Again, pursuant to Section 61(g), persons other than the trustor-transferor (or his spouse) obtain the reversion. Because the trust is irrevocable, the property will vest in children, not in H the trustor-transferor, at the end of 9 years. The same discussion of possible exclusions under Step 3 is relevant here. Section 64(a) is applicable, since the interests transferred to the children would be minority interests (less than 50%) in HW Ltd, and the two exceptions in Section 64 (c) and (d) are not pertinent. Since H is an "original coowner" in HW Ltd. however, his 12.38% transfer would be "counted" for

purposes of Section 64(d) and cumulated with prior and/or subsequent original coowner transfers of HW Ltd. interests, in determining a future change in ownership of HW Ltd. property.

2. Proposed Transaction No. 2 - excluded from change in ownership, Sections 62(a)(2) and 63.1.

Steps 1 and 2

The first step involving the transfer of Parcels C and A from HW Ltd. to H and W as community property is excluded from change in ownership under Section 62(a)(2) as a change solely in the method of holding title to the properties and in which the proportional ownership interests remain the same. The fact that H and W, as HW Ltd. partners, are "original coowners" does not trigger a change in ownership under Section 64(d), because the interests being transferred are real property interests, rather than partnership interests, per earlier discussion.

The second step involves the transfer of Parcels C and A to one or more irrevocable CLATs. Based on our understanding, a CLAT is a "Charitable Lead Annuity Trust" into which the grantor transfers property for the benefit of a charity which is the sole income beneficiary for a number of years, upon the expiration of which the remainder beneficiaries, who are family members, receive the remainder in the property at the termination of the income interest. The trust is irrevocable by the grantor and no interest is retained by the grantor, except the right to report all the income payable to the charity on the grantor's personal tax returns. Apart from the application of an exclusion, there is a present transfer (change in ownership) of beneficial interest in the property (Parcels A and C) transferred to the CLATs.

In the facts submitted, the charity will be the sole income beneficiary for the subsequent 10 to 12 years, at which time, the beneficial interests in the property (HW Ltd. interests) will vest in persons (C1, C2, and C3) other than the trustor-transferors. There is a change in ownership when real property is transferred to an irrevocable trust and the beneficial interests in the property do not vest/remain in the trustor-transferors. The Section 62(d) exclusion per Rule 462.160(b)(2) is not applicable for similar reasons, because the trustor-transferors do not remain or become the sole present beneficiaries upon termination of the CLATs. However, because the transfers constitute real property beneficial interests and will be made between parents and children, the parent/child exclusion in Section 63.1 would be applicable, providing a claim is timely filed and all other requirements are met.

Although H and W would be taking an extra step at the outset to transfer partnership real properties to themselves, the step transaction doctrine would not be applicable to this transaction because of the legislative intent stated in Section 63.1. In Penner v. Santa Barbara County, (1995) 37 Cal.App.4th 1672, the court held that the parent-child exclusion would have been applicable and the step transaction doctrine would not have been violated if the owner (mother) had first transferred the property to herself and her children and then to the partnership. Here, H and W are doing exactly that by transferring the parcels first to themselves and then to their children as the present beneficial owners of property in the CLATs. Section 63.1 would be applicable even if the children subsequently transfer their respective real property interests back to HW Ltd. or to a reconstituted partnership composed of parents and/or children. And although H and W are "original coowners," the parents' transfers should not be "counted" under Section 64(d) when undertaken for the purpose of following the steps described in the statement of legislative intent in Section 63.1.

3. Proposed Transaction No. 3 - no change in ownership under Section 64(a), parent/child exclusion not applicable.

The irrevocable transfer (assignment) by H and W of 40% of their interests in HW Ltd. to one or more CLATs, in which the charity will be the sole income beneficiary for the following 3 to 7 years and C1, C2, and C3 will retain the reversion and beneficial interest(s), is also excluded from change in ownership under Section 64(a), but **not** under Section 62(d). Because the property transferred (HW Ltd. interests) vests in C1, C2, and C3, persons other than the trustor-transferors, the trust exclusion in Section 62(d) is not applicable. (Section 61(g).) The fundamental difference between this and Proposed Transaction No. 2 above, is that the property transferred to the CLATs constitutes partnership interests rather than real property.

Because of this difference, the parent/child exclusion would **not** be applicable, since the property transferred is a 40% interest in HW Ltd. and not real property as required by Section 63.1(a). This transaction is similar to the situation in Penner v. Santa Barbara County, (1995) 37 Cal.App.4th 1672, where the transfer is not made directly between parents and children, but between the limited partnership and the children. The H and W partnership interests would be transferred from the limited partnership to the children, contrary to the plain language of the statute.

Notwithstanding the foregoing, Section 64(a) may be an applicable exclusion. In this proposed transaction, the HW Ltd. partners HW Ltd. will, in effect, transfer present beneficial ownership of 40% of their limited partnership interests to their three children. Assuming that no child will acquire control of HW Ltd. per Section 64(c), and assuming that the 40% does not represent more than 50% of the total capital and profits interests in HW Ltd. (per Section 64(d)), the assignment of 40% of H and W's limited partnership interest to C1, C2, and C3 does not constitute a change in ownership of the real property of the limited partnership.

The views expressed in this letter are, of course, advisory only and are not binding on the assessor of any county. You may wish to consult again with the appropriate assessor in order to resolve any remaining factual determinations and to confirm that the described properties will be assessed in a manner consistent with the conclusions stated herein.

Our intention is to provide courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this objective are appreciated.

Sincerely,

Kristine Cazadd
Senior Tax Counsel

Attachments

cc: Honorable Roger G.F. Fong
Sacramento County Assessor

Mr. James Speed, MIC:63
Mr. Larry Augusta, MIC:82
Mr. Richard Johnson, MIC:64
Ms. Jennifer Willis, MIC:70

h:\property\precednt\trustsle\1996\96008.kec