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October 1, 2007

**Re: Grandparent-Grandchild Exclusion**

Dear Mr. \_\_\_\_\_ :

This is in response to your January 12, 2007, letter to Robert Lambert, Acting Assistant Chief Counsel, in which you requested an opinion regarding the application of Revenue and Taxation Code<sup>1</sup> section 63.1 (grandparent-grandchild exclusion). Specifically, you asked whether a series of proposed transactions, involving an irrevocable trust, qualify for the exclusion. As discussed in more detail below, we conclude that at the time the grandchildren's remainder interests become vested, interests in the limited liability company (LLC) are held in trust rather than real property interests, and therefore, such transfer from the grandparent to the grandchildren does not qualify for the grandparent-grandchild exclusion.

**Factual Background**

Your letter states that G created a revocable trust to hold title to Blackacre. The trust became irrevocable upon G's death in 1994. Under the terms of the trust, G's child C is the sole present lifetime beneficiary of the trust, and upon C's death Blackacre is to be distributed to G's grandchildren (C's children).

For the purpose of maintaining continuity in the management of the trust assets, including Blackacre, the trustees propose to transfer Blackacre to an LLC in which the trust will be the sole member. You state in your letter dated January 12, 2007, that upon C's death, the LLC will transfer Blackacre to the trust and the trust will then distribute Blackacre to G's grandchildren. In your subsequent letter dated July 23, 2007, you state . . . "that the operating agreement of the proposed LLC would specify that the LLC is dissolved effective as of the date of C's death." The grandchildren will then transfer Blackacre back to the LLC in which they will be the sole members.

<sup>1</sup> All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

You also state that you believe no change in ownership will result from the proposed transfers because the grandparent-grandchild exclusion will apply and the step transaction doctrine should not be applied to the transfers under Statutes 1987, chapter 48, section 2, as amended by Statutes 2006, chapter 224, section 6 (SB 1607).

## **Discussion**

### **Change in Ownership Generally**

Section 60 defines a “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.” A change in ownership does not include the transfer of real property to a revocable trust. (Rev. & Tax. Code, § 62, subd. (d); Property Tax Rule 462.160, subd. (b)(2).) However, a change in ownership occurs at the time a revocable trust becomes irrevocable unless the trustor-transferor or his or her spouse is the sole present beneficiary or unless the transfer is otherwise excluded from change in ownership. (*Ibid.*)

### **Step 1 – Transfer of Blackacre to C**

In this case, upon G’s death in 1994, the trust became irrevocable. (See Property Tax Rule 462.260, subd. (d)(1).) C, as the sole present beneficiary of the trust, became the present beneficial owner of Blackacre. Our understanding is that this transfer qualified for the parent–child exclusion under section 63.1.

### **Step 2 – Transfer of Blackacre to LLC During C’s Lifetime**

Section 62, subdivision (a)(2), implemented by Property Tax Rule<sup>2</sup> 462.180, subdivision (b)(2), provides in relevant part that transfers of real property by an individual or individuals 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 each and every piece of real property transferred remain the same before and after the transfer do not constitute changes in ownership of the real property.

Accordingly, the transfer of Blackacre to the LLC during C's lifetime does not constitute a change in ownership of Blackacre under section 62, subdivision (a)(2) because she will maintain her 100 percent ownership in Blackacre after the transfer.

### **Step 3 – Transfer of LLC Interest to C’s Children**

Proposition 193, effective March 27, 1996, is a constitutional amendment approved by the voters of California, which excludes from change in ownership and reassessment transfers of real property from grandparents to grandchildren, provided that the parents of the grandchildren

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<sup>2</sup> Property Tax Rules are promulgated under title 18 of the California Code of Regulations.

who qualify as children of the grandparents are deceased as of the date of transfer.<sup>3</sup> Proposition 193 is incorporated into article XIII A, section 2, subdivision (h)(2) of the California Constitution and codified by section 63.1.

Among other requirements, article XIII A, section 2, subdivision (h)(2), of the California Constitution provides that the grandparent-grandchild exclusion only applies to a purchase or transfer of real property from grandparents to their grandchild or grandchildren, as defined by the Legislature. The statutory provisions adopted by the Legislature to implement the grandparent-grandchild exclusion have defined the terms “grandchild” and “grandchildren,” and “eligible transferor” and “eligible transferee” in section 63.1, subdivision (c), so as to make it clear that they cannot be business entities such as corporations, partnerships, and LLCs. In addition, the definition of “real property” contained in section 63.1, subdivision (c)(8), provides that “real property” does not include any interest in a legal entity. Together, these definitions require that an eligible transferor (grandparent) must transfer real property, not an interest in a legal entity, to an eligible transferee (grandchild) in order to qualify for the exclusion. In other words, a transfer of an interest in an LLC holding real property from a grandparent to a grandchild will not qualify for the exclusion nor will transfers to or from an LLC to a grandchild. Therefore, the proposed transfer of LLC interests to C’s children at C’s death does not qualify for the grandparent-grandchild exclusion.

**Step 4 – Transfer of Blackacre from LLC to Grandchildren and**  
**Step 5 – Transfer of Blackacre to LLC by Grandchildren**

Section 62, subdivision (a)(2), implemented by Property Tax Rule 462.180, subdivision (b)(2), provides in relevant part that transfers of real property by an individual or individuals 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 each and every piece of real property transferred remain the same before and after the transfer, do not constitute changes in ownership of the real property. Thus, the transfer of Blackacre from G’s grandchildren to an LLC wholly owned by them, or vice versa, would not constitute a change in ownership so long as the grandchildren’s proportional interests in Blackacre were the same before and after the transfers.

**Step-Transaction Doctrine**

The step-transaction doctrine applies 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. Prior to SB 1607, the only exception to the application of the step-transaction doctrine is the series of transfers described in the uncodified 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. Prior to SB 1607, the Legal Department advised assessors and taxpayers that the grandparent-grandchild exclusion was subject to the step-transaction doctrine, even though the parent-child exclusion, which is also contained in

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<sup>3</sup> Commencing fiscal year 2006-07, in determining whether all of the parents of a grandchild are deceased, an in-law child of the grandparent that is a stepparent to the grandchild does not have to be deceased on the date of the transfer. (Rev. & Tax. Code, § 63.1, subd. (a)(3)(A).)

section 63.1 was not subject to the step-transaction doctrine. However, in 2006, Senate Bill 1607 (2005-2006 Reg. Sess.) was enacted as Statutes 2006, chapter 224. Senate Bill 1607 amended Statutes 1987, chapter 48, section 2 to read:

Sec. 2. (a) 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 both of the following:

(1) 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.

(2) Proposition 193 on the March 26, 1996, primary election ballot to exclude from change in ownership purchases or transfers between grandparents and their grandchildren described therein.

(b) Specifically, transfers of real property from a corporation, partnership, trust, or other legal entity to an eligible transferor or transferors, where the latter are the sole owner or owners of the entity or 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 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 satisfy the requirements of Section 63.1.

(c) Except as provided herein, this section shall not 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.

Accordingly, the step-transaction doctrine no longer applies to transfers seeking to qualify for the grandparent-grandchild exclusion. However, relief from the step-transaction doctrine does not mean that interests in legal entities such as LLCs will now be treated as “real property” for purposes of the grandparent-grandchild exclusion in contravention of the express language of section 63.1, subdivision (c)(8). Therefore, relief from this doctrine will not remedy the problems associated with having the LLC interest, and not Blackacre, held in the trust at the time G’s grandchildren’s rights to the present enjoyment of their remainder interests in the trust vest. In other words, Step 3 discussed above results in a change in ownership because the

grandchildren (C's children) obtained 100 percent in the LLC interest rather than real property interests. (See *Penner v. County of Santa Barbara* (1996) 37 Cal.App.4<sup>th</sup> 1672.)

The views expressed herein are advisory only and are not binding on any person or governmental entity. This is a staff opinion, which is based on the existing law and the facts as we understand them.

Sincerely,

*/s/ Tim Treichelt*

Tim Treichelt  
Supervising Tax Counsel

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cc:

cc: Mr. David Gau (MIC:63)  
Mr. Dean Kinnee (MIC:64)  
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