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August 24, 2006

TO: STATE BOARD OF EQUALIZATION

RE: Property Tax Rule 462.040 – Joint Tenancy

The California Assessors' Association (CAA) has been approached by staff at the state to review the rule, and to see whether we are interested in revising the rule. We are, and we advocate five changes to the current rule.

In 2003, certain changes to the rule were made that had a variety of consequences that were unforeseen and unintended by the parties who advanced those changes. The essential purpose of the amendments in 2003 was to allow registered domestic partners an avenue for transferring property without the burden of a reassessment. Effectively, in 2006 that was accomplished with the passage of SB 565. However, the changes to the Property Tax Rule have opened the door to some very serious and unforeseen dilemmas.

In any discussion of the property tax rule on joint tenancy, it is important to understand the original intent of the "original transferor" exclusion. The Legal Division at the State Board of Equalization wrote a letter in 1987 to an individual who was questioning the way the exclusion was being interpreted. It stated in part:

> "In order to understand what the Legislature had in mind in enacting the joint tenancy provisions relating to change in ownership it is helpful to refer to two reports which were prepared for the Legislature's benefit. The first is the Report of the Task Force on Property Tax Administration dated January 22, 1979 which was presented to the Assembly Committee on Revenue and Taxation. … The second report is entitled Implementation of Proposition 13, Volume 1, Property Taxes Assessment dated October 29, 1979 and was prepared by the staff of the Assembly Revenue and Taxation Committee."

The letter went on to quote from the first report:

> "3. Tenancies-in-Common and Joint Tenancies.
> …
> "Under the Tax Force recommendations separate accounting is not required for 'family' joint tenancies, which are the great majority of joint tenancies in this state. Thus the new burden on assessors is limited only to co-tenancies which don't fit under the 'family' joint tenancy rule and are not interspousal co-tenancies. That group of co-tenancies should not be numerous.

> "4. <u>'Family' Joint Tenancies</u>. Probably the vast majority of joint tenancies in California (other than interspousal joint tenancies) are those in which a parent places his property in joint tenancy with children. The special aspect of a joint tenancy (as distinguished from tenancy-in-common) is that the surviving joint tenant (or joint tenants) succeeds to the entire property by operation of law on the death of the other joint tenant. For that reason joint tenancy is often used as a substitute for a will. The same consideration which justifies excluding the making of a will from change in ownership also supports exclusion of the <u>creation</u> of a joint tenancy where the transferor (e.g., a parent) is one of the joint tenants. The rights of the new joint tenants (e.g., the children) to obtain the entire property outright are contingent upon their surviving the transferor joint tenant. Creation of such joint tenancies is not a change in ownership, but the entire property is reappraised when the joint tenancy terminates."

The report recognized that some of the joint tenancies that might fall under the general rule would not be 'family' joint tenancies. However, the *reason* they wanted to create the rule was because they believed that a vast majority of joint tenancies were 'family' joint tenancies. Because people were often using joint tenancy for estate planning, they wanted to find a reason to exclude these transfers. The exclusion was justified by saying *" joint tenancy is often used as a substitute for a will. The same consideration which justifies excluding the making of a will from change in ownership also supports exclusion of the <u>creation</u> of a joint tenancy where the transferor (e.g., a parent) is one of the joint tenants. The rights of the new joint tenants (e.g., the children) to obtain the entire property outright are contingent upon their surviving the transferor joint tenant."*

Back in 1978 to 1980, when this exclusion was formulated, joint tenancy was an established method of estate planning for many people. However, since that time, estate planning has changed a great deal. Trusts and family limited partnerships have become more common than joint tenancy as estate planning tools. In fact, joint tenancy is frequently identified as an estate plan to be *avoided.* The type of estate planning commonly used in 1980 (joint tenancy) is incompatible with the type of estate planning commonly used today (trusts). As responsible guardians of the public good, we should not encourage people to take irresponsible risks with their property titles by trying to mix the two types.

[NOTE: The CAA believes, in fact, there is no longer any need for the original transferor exclusion. The Legislature was trying to cushion any assessment impact for family transfers. Other exclusions are now in place to protect family transfers, however. There is a parent/child exclusion, a grandparent/grandchild exclusion, and most recently, a domestic partner exclusion. Of course, elimination of the original transferor exclusion would require legislation, and is not the focus of this request. Nevertheless, this is the ultimate goal of the CAA.]

In discussing the five changes to Property Tax Rule 462.040 that we would like to see, we have kept the Legislative intent in approving the original rule in mind.

1. Our first and most immediate problem is that of trusts in joint tenancies. We understand the intent behind the rule change was to allow registered domestic partners to take advantage of the exclusion, and that it was merely attempting to broaden the original intent of a 'family' joint tenancy.

Unfortunately, the addition of trusts to joint tenancy has created even more chaos than the rule with its concept of 'original transferors' did originally. There may be some circumstances where judges have ruled that a trust may be a joint tenant. However, unless a court rules in an individual case that a trust is a joint tenant, a trust (a legal entity that cannot die) should not be allowed as a joint tenant. The real and potential problems that can occur with trusts as joint tenants were both unanticipated and unintended by the Board.

Attached, as Exhibit A, is a chart outlining some of the problems being experienced by the counties, and examples of exclusion usage that were unintended by the drafters.

Attached, as Exhibit 1, is a proposed revision to the Property Tax Rule to implement the removal of trusts.

[**Note**: Each suggestion below is followed by another Exhibit with proposed wording revisions to the rule, and each suggestion has changes to the wording of the rule in different colors. Each Exhibit builds on the suggestions that have preceded it. Changes to each exhibit are as follows: Exhibit 1 – blue. Exhibit 2 – green. Exhibit 3 – dark red. Exhibit 4 – purple. Exhibit 5 – pink.]

2. Our second concern is the interpretation that allows a change in vesting to create original transferors. Until 2003, the interpretation of the code was that a change in vesting only (A and B as tenants in common to A and B as joint tenants) was a change in vesting only. No original transferors would be created. This is consistent with the Legislative intent as indicated in the two reports. If parents were on title and added a child or children as joint tenants, or if two individuals were on title and they added the spouse of one of the individuals, then original transferors would be created. A change in the vesting only that triggers this exclusion was never intended, nor even contemplated, originally.

Attached, as Exhibit B, is a chart outlining some of the problems being experienced by the counties, and examples of exclusion usage that were unintended by the drafters. Please note especially Example 1 in the chart, and the applicant's position which the Appeals Board found "compelling." The applicant argued that there is "…no support or citation…" to the position that the legislative intent of Property Tax Rule 462.040 is for estate planning purposes, and is not <u>designed to be used as a tool to circumvent a reassessment</u>. Naturally, an applicant will use any argument, erroneous or not, to win his case. But when the Appeals Board of a major county can find nothing in the rule to contradict such an inaccurate and specious representation of the rule's intent, it is time to consider clarifying the wording and examples.

Attached, as Exhibit 2, is a proposed revision to the Property Tax Rule to implement the revision to the interpretation as outlined above.

3. Third on our list of concerns and our suggestion for aligning the rule with the original Legislative intent is that of overlapping original transferors. Under current interpretation, suppose that Beth owns a piece of property. Beth grants to herself and her niece Heather as joint tenants. Beth becomes an original transferor. Now, if Beth and Heather grant to Beth, Heather, and Heather's husband George, all three of them become original transferors (Beth and Heather because they are both the transferors and transferees in the joint tenancy, and George because he is the spouse of an original transferor). If Beth dies, or later grants to

Heather and George, or either of them individually, there is no reassessment, because the interest is going to an original transferor. It is not difficult to see how now Heather and George can go on to create another joint tenancy, while the property escapes reassessment for years.

In the second report referenced above (Implementation of Proposition 13, Volume 1, Property Taxes Assessment dated October 29, 1979), it states in part:

> "Operation of Present Law. In determining whether a joint tenancy transaction constitutes a change in ownership, and if so the extent to which the property would be reappraised, AB 1488 introduced and AB 1019 refined the concept of an 'original transferor'.
>
> "An 'original transferor' is one or more persons who hold joint tenancy interests in property immediately after a complete turnover of the previous original owners occurs. For joint tenancies created prior to March 1, 1975, it is rebuttably presumed that all owners as of that date are original transferors. The spouse of an original transferor is also considered to be an original transferor, even if he/she was added as an owner after the original acquisition. **After the point in time at which the original ownership is established, no subsequent joint tenants who are added to the current ownership (except the spouses just mentioned) are treated as 'original transferors'** (Section 65(a)). (Emphasis added.)

The report goes on to give examples:

> "Examples. This rather complex treatment is designed to protect family joint tenancy interest, and those of original owners. The following examples show the operation of these provisions:
>
> "(4) Two friends, X and Y, purchase a small business as joint tenants in 1978. In 1980 they become co-original transferors by adding Y's spouse and associates R and S as co-joint tenants. Result: no reappraisal.
>
> "Barring any other intervivos transfer of interest, no reappraisal will occur until the survivor of X, Y, and Y's spouse dies, at which time there would be a 100% reappraisal.
>
> "However, if X transfers intervivos to any party (current joint tenant or new person, a 50% reappraisal will occur (X held one-half of original interest). Likewise with Y unless Y transfers to Y's spouse, in which case the interspousal exemption applies. If Y's spouse transfers to anyone other than Y, a 20% reappraisal would occur (assumes one-fifth equal shares prior to transfer).
>
> "If R or S were to transfer to the other alone, or to a new party T, then a similar 20% reappraisal would occur, due to the one-fifth interest of each. But if they transfer only to X, Y or Y's spouse, or to all remaining joint tenants, no reappraisal occurs.
>
> "It should be noted that the original transferor is not allowed the option of transferring intervivos to either the other original transferors (if any) or to all remaining joint tenants – as non-original transferors are allowed to do—without incurring reappraisal; escape

> from reappraisal is allowed to an original transferor only upon the transfer of his/her interest at death, i.e., 'by operation of law'.

Very clearly, the Legislative intent was not to avoid reassessment entirely, particularly by any intervivos steps. It allowed the exclusion when the transfer was 'by operation of law,' or in other words, at the death of any joint tenant, but only until all of the original owner transferors were gone. If wording to this intent had been included, or if the example had been added to the rule, step-transactions in joint tenancies would have been virtually impossible. What we would like is to add some of those safeguards into the rule.

Attached, as Exhibit 3, is a proposed revision to the Property Tax Rule to implement the revision to the interpretation as outlined above.

4. Fourth on the list is to address owners with unequal interests becoming original transferors without a reassessment. You will see examples in the Exhibit B regarding tenants in common with unequal interests becoming original transferors. Prior to the change in 2003, the State had previously revised its interpretation of the rule to allow for this when additional joint tenants were added. For example, Mark owns a 5% interest and Donna owns a 95% interest in property as tenants in common. Mark and Donna grant to themselves and Jane, Mark's wife, all as joint tenants. Now, the State's opinion is that Mark, Jane, and Donna are all original transferors, and there is no reassessment. If Donna, who originally owned 95% of the property, deeds to Mark and Jane, or to either of them individually, there would be no reassessment, since both Mark and Jane are original transferors.

By reviewing Example 4 from the second report, as quoted above, the Legislative intent was not to allow original owners to transfer *intervivos* percentages of interest without a reassessment. Rather, it was to allow either single or equal joint original owners to use an estate planning tool that was in vogue at the time the exclusion was passed. We would now like to close this loophole, and return the exclusion to a much closer interpretation of what the Legislature intended.

Attached, as Exhibit 4, is a proposed revision to the Property Tax Rule to implement the revision to the interpretation as outlined above.

5. Finally, we would like to reverse a 1999 amendment to the rule. We do not believe this change follows the requirements of the statute under Revenue and Taxation Code section 65(b).

The amendment was stated as follows: "If a spouse of an original transferor acquires an interest in the joint tenancy property either during the period that the original transferor holds an interest *or by means of a transfer from the original transferor*, such spouse shall also be considered to be an original transferor." (Emphasis added.) In addition, Example 7-2 was added to the rule.

Revenue and Taxation Code section 65(b) states:

> There shall be no change in ownership upon the creation or transfer of a joint tenancy interest *if the transferor or transferors, after such creation or transfer, are among the joint tenants.* Upon the creation of a joint tenancy interest described in this subdivision,

> the transferor or transferors shall be the "original transferor or transferors" for purposes of determining the property to be reappraised on subsequent transfers. The spouses or original transferors shall also be considered original transferors within the meaning of this section. (Emphasis added.)

The code requires that the transferor be among the joint tenants "after such creation or transfer." The rule allows for an exception not stated in the code – that the transferor *not* be among the joint tenants, but that a spouse who was not on title can be given the interest by an original transferor who is coming off title.

Attached, as Exhibit 5, is a proposed revision to the Property Tax Rule to implement the revision to the interpretation as outlined above.

In summary, the California Assessor's Association (CAA) would like to eliminate the original transferor exclusion entirely. Since this will involve legislation, it will be an item on the CAA's Legislative Committee's upcoming agenda. Any legislation takes time, however, and there are items of concern in the existing rule. In order of priority, the most urgent and immediate changes needed are:

- First, remove of any mention of trusts within a joint tenancy.
- Second, return the requirement for an additional person to be added before the exclusion can be triggered.
- Third, close the loophole allowing additional original transferors to be created (other than a spouse) until all of the primary original transferors are gone.
- Fourth, equalize by reassessment when grantors with unequal interests become original transferors.
- Fifth, require a grantor original transferor to remain on title as a grantee in order for a spouse also to acquire original transferor status.

Thank you for your assistance in this endeavor.

Sincerely,

Rick Auerbach
President, California Assessors' Association

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