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December 22, 2008

Honorable Tom J. Bordonaro, Jr.
San Luis Obispo County Assessor
County Government Center
1055 Monterey Street, Suite D-360
San Luis Obispo, CA 93408-1003

Attn: , *Assessment Manager*

*Re: Change in Ownership – Trusts and Later Acquired Properties; Parent-Child and Grandparent-Grandchild Exclusions
Assignment No. 08-005*

Dear Mr. Bordonaro:

This is in response to your December 17, 2007, letter to us regarding the availability of the grandparent-grandchild exclusion from change in ownership for certain transfers of real property from a trust where the trustor never owned the property that was purchased by the trust after the trustor's death ("later acquired property"). The conclusion of Property Tax Annotation¹ (Annotation) 625.0230, with which we agree, is that the parent-child and grandparent-grandchild exclusions are unavailable for the transfer of real property that was never actually owned by the transferor. However, we will address your questions as an opportunity to further illuminate our analysis. As explained below, later acquired property does not qualify for the parent-child or grandparent-grandchild exclusion when the beneficial ownership vests in the trust's remainder beneficiaries, even if the trustor and the remainder beneficiaries would otherwise be considered eligible transferors and transferees, because later acquired property is not "real property... of an eligible transferor" within the meaning of subdivision (a)(2) of section 63.1.

Facts

Grandmother died,² and an Order for Preliminary Distribution (the Order) was recorded in Los Angeles County in 1974, which left various assets in trust to Grandmother's daughter

¹ Property Tax Annotations are summaries of the conclusions reached in selected legal rulings of Board counsel published in the Board's Property Tax Law Guide. (See Cal. Code Regs., tit. 18, § 5700 for more information regarding annotations.) The annotations cited in this letter are available on the Board's Website at <http://www.boe.ca.gov/proptaxes/pdf/220.pdf>.

² The exact date of her death is unknown.

(Parent), as trustee and income beneficiary for her lifetime. In 1978, Parent, as trustee of the trust, used trust assets to purchase the subject real property, which was then held in the trust. No subsequent transfers have been recorded. Parent died on April 29, 2007, and was survived by two living children (grandchildren), and living children (great-grandchildren) of her two predeceased children. Parent's surviving descendants became income beneficiaries of the trust property on Parent's death; eventually the trust property will be distributed to Parent's surviving descendants or contingent beneficiaries in accordance with the terms of the trust.

In your letter you ask the following questions to assist you in determining the change in ownership treatment upon Parent's death:³

Normally, we are advised to look at the grantor of a remainder interest for exclusion purposes. Any transfer from the life estate holder would be a restricted transfer, and as such, would not be eligible for exclusion. So, in normal circumstances, following the death of Parent, Grandparent would be the transferor, and the two [grand]children who survived Parent's death would potentially be eligible for a grandparent/grandchild exclusion. Any interest passing to Grandparent's great-grandchildren would be a reassessable change in ownership.

Property Tax Annotation 625.0230 opines that when the transferor never owns an interest in the property, the exclusion pattern changes. The letter implies that neither the trustor/transferor nor the life estate holder is an eligible transferor. It does not say who the eligible transferor should be, or whether a reassessment is needed.

In our particular case, who is the transferor for exclusion purposes? Is it Grandparent or is it Parent? If there is no eligible transferor, what is the reasoning? Should there be a reassessment, and if so, for how much? What percentage of the property is eligible for exclusion? If no exclusion is available, what is the explanation for how a property clearly owned by a family, where interest clearly passes to individuals one thinks of as either children or grandchildren, is not eligible for exclusion?

Law and Analysis

Article XIII A, section 2 of the California Constitution requires the reassessment of real property upon a "change in ownership." A change in ownership is defined in section 60 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."

"Change in ownership" includes any "vesting of the right to possession or enjoyment of a remainder or reversionary interest that 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

³ Names of the parties have been replaced with "Grandparent," "Parent," "grandchildren," and "great-grandchildren," as appropriate.

Section 63," which apply to transfers in trust for the benefit of the trustor and/or the trustor's spouse and interspousal transfers, respectively. (Rev. & Tax. Code,⁴ § 61, subd. (g).) A life estate is an estate for use of or income from property, whose duration is limited to the life of a person holding it or the life of some other person; no particular language is required to create a life estate. (Annotation 220.0786.) In general, the creation, transfer or termination of a life estate is a change in ownership. (Property Tax Rule⁵ 462.060, subd. (a).)

Change in ownership occurs upon a transfer of real property to an irrevocable trust, or when any person other than the trustor becomes the present beneficiary of an irrevocable trust, unless an exclusion applies. (Rule 462.160, subds. (a) and (b)(1).) Change in ownership also includes the termination of a trust or a portion thereof, unless an exclusion from change in ownership applies. (Rule 462.160, subds. (c) and (d).)

As you know, the parent-child and the grandparent-grandchild exclusions from change in ownership were established in article XIII A, section 2, subdivision (h) of the California Constitution by means of Propositions 58 and 193, and implemented by the Legislature in section 63.1. The parent-child exclusion is available for purchases or transfers⁶ of real property between parents to their children occurring on or after November 6, 1986, and the grandparent-grandchild exclusion is available for transfers of real property from grandparents to their grandchildren occurring on or after March 27, 1996 (Rev. & Tax. Code, § 63.1, subd. (h)), but only if a timely claim is filed for the exclusion (Rev. & Tax. Code, § 63.1, subds. (d) and (e)). However, the grandparent-grandchild exclusion will only apply if all of the children of the grandparent who qualify as parents of the grandchild are deceased prior to the transfer (although a stepparent to a grandparent's grandchild does not need to be predeceased). (Rev. & Tax. Code, § 63.1, subd (c)(2).) (We assume that this requirement is met.) Both exclusions are available for transfers through the medium of an inter vivos or testamentary trust (Rev. & Tax. Code, § 63.1, subd. (c)(9)).

Subdivision (a)(2) of section 63.1 provides that the parent-child exclusion is available for the transfer of real property that is the principal residence of the transferor, and the transfer of the first \$1,000,000 of full cash value of "all other real property *of an eligible transferor*."
(Emphasis added.) This provision is sometimes referred to as the "\$1,000,000 limit for other real property." For the grandparent-grandchild exclusion, the \$1,000,000 limit for other real property includes the following limitation:

The full cash value of any real property, other than a principal residence, that was transferred to the grandchild or grandchildren pursuant to a purchase or transfer that was excludable pursuant to paragraph (2) of subdivision (a) and the full cash value of a principal residence that fails to qualify for exclusion as a result of the preceding sentence shall be included in applying, for purposes of paragraph (3) of subdivision (a), the one million (\$1,000,000) full cash value limit specified in paragraph (2) of subdivision (a).)

⁴ All statutory references are to the Revenue and Taxation Code, unless otherwise specified.

⁵ Property Tax Rules or "Rules" are sections of title 18 of the California Code of Regulations.

⁶ For purposes of this letter, we will refer only to "transfers."

In this case, we assume that sufficient parent-child and grandparent-grandchild limit amounts are available to apply to the transfer. The interpretation of section 63.1, subdivision (a)(2)'s requirement that the transferred property be "real property of an eligible transferor" is the key to our analysis and is discussed below.

1. In our particular case, who is the transferor for exclusion purposes? If there is no eligible transferor, what is the reasoning?

Brief Answer: For change in ownership and exclusion purposes, Grandmother is the transferor of the remainder interests to her grandchildren and great-grandchildren. The Board's longstanding position has been that a transfer of trust property to a remainder beneficiary occurring upon the death of a life beneficiary is a transfer from the trustor and not from the life beneficiary.

Analysis: As an initial matter, we note that transfers of real property through the medium of a revocable or irrevocable trust are treated as occurring between individuals, and not between individuals and trusts as entities. That is, for property tax purposes we "look through the trust" to determine the parties to any transfer. Therefore, the change in ownership consequences of transfers to and from trusts are dependent upon the identities of the individual transferors and the individual transferees of present beneficial interests in trust real property, and are not dependent on the identities of the trustees who hold bare legal title to trust property.

(Annotation 220.0761.)

Generally, trustors are considered to be the transferors of real property that passes to beneficiaries, including remaindermen, under the terms of their trust instruments. For example, if A transfers Blackacre to an irrevocable trust in which B has a life estate and C holds the remainder interest, for property tax purposes A is the transferor of the beneficial interests in Blackacre that pass to both B and C under the terms of A's trust instrument. (See Annotations 220.0780 and 220.0786.)

As you noted in your letter, we have previously opined in Annotation 625.0230 that the same rule still applies when a trust purchases the real property and the trustor never owned the property. For real property purchased by an irrevocable trust, subsequent transfers of present beneficial interests in the real property under the terms of the trust instrument are treated as transfers between the trustor and the beneficiaries, as explained above. Therefore, if trustor A owns Blackacre and the trustee sells it, purchases Whiteacre, and transfers Whiteacre to C upon the termination of B's life estate, for change in ownership purposes trustor A will be treated as the transferor of Whiteacre to C.

In this case, Grandparent is the creator of the remainder interests pursuant to the terms of the trust. Parent, as life beneficiary, only has the right to enjoy the property during her lifetime, and never has the power to direct the disposition of the property either during her life or upon her death. Because Parent is not the transferor, the parent-child exclusion is not available and thus is not relevant to our analysis.

For purposes of the parent-child and grandparent-grandchild exclusions, subdivision (b)(6) of section 63.1 provides that an "[e]ligible transferor" means a grandparent, parent, or child of an eligible transferee," and subdivision (b)(7) provides that an "[e]ligible transferee" means a parent, child or grandchild of an eligible transferor." An "eligible transferor" for purposes of these exclusions is defined solely in terms of family relationships. We therefore conclude that while Grandmother could be considered an "eligible transferor" with respect to all of the *qualifying* property transferred to the remaindermen under the terms of her trust, this conclusion is not dispositive with respect to the subject property because property acquired by the trust after her death is not "other real property of an eligible transferor."

2. Should there be a reassessment, and if so, for how much? What percentage of the property is eligible for exclusion?

Brief Answer: Because the property itself is not "other real property of" Grandmother, no exclusion is available and there should be a reassessment of the entire property.

Analysis: The transfer of the subject property is not eligible for the grandparent-grandchild exclusion because the property itself does not qualify for the exclusion. The \$1,000,000 limit for other real property may only be used to exclude a transfer of "real property of an eligible transferor," including the "transfer of the present beneficial ownership of property from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust." (Rev. & Tax. Code, § 63.1, subds. (a)(2) and (c)(9).) Because the trust acquired the property after Grandmother's death, Grandmother never had beneficial ownership of the property.

The April 6, 1992, opinion letter upon which Annotation 625.0230 is based involved "Trust B," a survivor's trust funded with deceased "Mom's" property, in which "Dad" had a lifetime income interest. The trust purchased two parcels that were ultimately transferred to their Son upon Dad's death in 1990. We concluded that Mom was the transferor of Trust B's real property, but that the parcels acquired by Trust B after Mom's death were not eligible for Mom's parent-child exclusion because she never owned an interest in them. We explained that:

From the foregoing provisions,^[7] it is clear that a \$1,000,000 exclusion is available with respect to real property of an eligible transferor, i.e., property which is or was owned by an eligible transferor and then transferred to an eligible transferee.

* * *

Assuming none of the Trust 'B' real property was transferred to Son by Dad, that property, excluding any interest in the Later Acquired Parcels,^[fn. omitted.] would constitute transfers from Mom (Parent) to Son at the time of Dad's death and would be part of Mom's (Parent's) \$1,000,000 exclusion...No part of Trust 'B's' interest in the Later Acquired Parcels would constitute transfers from Mom (Parent) to Son because Mom (Parent) never owned any interest in the Later Acquired Parcels...

⁷ "Former subdivisions (a)(2), (b)(2), (c)(1) (4),(5), and (7), and (f) of section 63.1."

* * *

As indicated above, Mom (Parent) is not an eligible transferor of any portion of the Later Acquired Parcels allocated to Trust 'B'. Mom (Parent) would be an eligible transferor, however, as to fifteen percent (15%) of Trust 'B's' interest in the other real property....

While the letter does not consider Mom an eligible transferor of the Later Acquired Parcels because she never owned them, we believe that the letter was primarily interpreting subdivision (a)(2) of section 63.1 to exclude from the definition of "other real property of an eligible transferor" any property not actually owned by the transferor. (See first quoted paragraph above.) Therefore, we clarify that property that was never owned by a transferor cannot ever be "property. . .of" that transferor within the meaning of subdivision (a)(2) of section 63.1.

You ask how no exclusion might be available for property that is clearly owned by a family and which clearly has passed to either children or grandchildren. That the property is being transferred among different generations of the same family does not affect our analysis, as the parent-child and grandparent-grandchild exclusions do not apply to all inter-generational transfers of property or interests therein. Propositions 58 and 193 and implementing legislation placed significant limitations on the types of persons and properties to which the exclusions may apply. For example, neither exclusion applies to the transfer of interests in family-owned legal entities that solely own real property, even though such transfers could arguably satisfy the public policy purposes of the exclusions. (See *Penner v. County of Santa Barbara* (1995) 37 Cal.App.4th 1672, 1677-1678.) Furthermore, the examples of transfers cited in the Proposition 58 ballot pamphlet (copy enclosed) all imply prior ownership of the property by the transferors (parents aiding children in purchasing a first home by taking title in the name of the parent; inherited property; and property associated with family businesses and farms).⁸

In this case, the trust's provisions govern the beneficial enjoyment and disposition of the trust property, and provide the trustee with the power to invest and reinvest the trust assets. The Parent-as-trustee's decision to acquire the property subject to the terms of the trust means that the Parent-as-beneficiary enjoyed the benefits of the property under the terms of the trust. The Parent must therefore accept the consequences of owning and enjoying property in a particular legal form (see *Penner, supra*, at p. 1679), which means in this case that the benefit of the grandparent-grandchild exclusion is not available to the successor generations.

⁸ "Ballot summaries and arguments are accepted sources from which to ascertain the voters' intent and understanding of initiative measures." (*Penner, supra*, at p. 1677.)

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.

Very truly yours,

/s/ Carole F. Ruwart

Carole F. Ruwart
Tax Counsel III (Specialist)

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Enclosure

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