



STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082
TELEPHONE 714-796-1667 • FAX 714-558-4254
www.boe.ca.gov

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June 22, 2007

Re: Parent-Child Exclusion

Dear Ms. --- :

This is in response to your May 15, 2007 letter addressed to Tom Hudson, Tax Counsel III (Specialist) in Honorable Board Member Bill Leonard's office, requesting an opinion as to whether the transfer of a 50 percent interest in a family limited partnership (partnership) from a mother to a daughter resulted in a change in ownership of the real property owned by the partnership (the property). In our opinion, the transfer resulted in a change in ownership of the property if, after the transfer, daughter owned more than 50 percent of the profits and capital interest in the partnership. Furthermore, such a transfer does not qualify for exclusion under Revenue and Taxation Code¹ section 63.1, the parent-child exclusion, since that exclusion applies only to the transfer of real property interests between parents and children, and not to the transfer of legal entity interests.

Factual Background

Your client, mother (M), gave her daughter (D) a 10 percent interest in real property. This transfer was excluded from reassessment under the parent-child exclusion. D then transferred her 10 percent interest in the property, and M transferred her 90 percent interest in the property to the partnership in exchange for the same proportional ownership interests in the partnership.² Thereafter, M transferred a 50 percent interest in the partnership to D.³ After this transfer, M owned a 40 percent interest and D owned a 60 percent interest in the partnership. You state that M has been, and continues to be, the sole general partner of the partnership, and that at no time, from the inception of the partnership to the present, did D ever own a general

¹ All statutory references are to the Revenue and Taxation Code unless stated otherwise.

² While you do not state, we assume that this transfer was excluded from change in ownership under section 62, subdivision (a)(2), and as a result, M and D became "original co-owners" pursuant to section 64, subdivision (d).

³ You do not state, however, whether the ownership interests transferred were interests in both the capital and profits of the partnership.

partnership interest.

You state that the --- County Assessor (assessor) reassessed the property owned by the partnership, asserting that the partnership underwent a change in control pursuant to section 64, subdivision (c)(1) and Property Tax Rule 462.180, subdivision (d)(1)(B). The assessor further asserted that M's transfer of a 50 percent interest in the partnership is not excludable under the parent-child exclusion. In your opinion, the assessor erred in finding that a change in ownership occurred. For the reasons explained below, we agree with the assessor.

Legal Analysis

Section 60 defines a change in ownership as: (1) a transfer of a present interest in real property, (2) including the beneficial use thereof, (3) the value of which is substantially equal to the value of the fee interest. Section 64, subdivision (a), generally provides that a transfer of ownership interests in a legal entity, such as a limited partnership, does not constitute a transfer of the real property held by the entity. Section 64, subdivision (c)(1) provides, however, that:

When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, *or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity* through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities . . . the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained. (Emphasis added.)

"Control" is further defined and applied to partnerships specifically in Rule 462.180, subdivision (d)(1)(B), which states that a change in ownership occurs when a partnership, limited liability company or other legal entity:

obtains through multi-tiering, reorganization, or any transfer direct or indirect ownership of *more than 50 percent of the total interest in partnership or LLC capital and more than 50 percent of the total interest in partnership or LLC profits*. . . . (Emphasis added.)

Thus, under Property Tax Rule 462.180, subdivision (d)(1)(B), a change in control of a partnership occurs when a person or legal entity has obtained more than a 50 percent interest in partnership capital and partnership profits.

In your case, initially, M transferred a 10 percent interest in property to D. This transfer was followed by the formation of the partnership and the transfer of M and D's interests in the property to the partnership in exchange for the same proportional ownership interest in the partnership. Based on these facts, it appears that both of these transfers were properly excluded from change in ownership. (See Rev. & Tax. Code, §§ 63.1 and 62, subd. (a)(2).)

However, these transfers were followed by the transfer of 50 percent of M's partnership interest to D, resulting in D owning 60 percent and M owning 40 percent of partnership. Because D owned 60 percent of partnership after the transfer, this transfer caused a change in control of the partnership within the meaning of section 64, subdivision (c)(1), and a change in ownership of all the real property held by the partnership resulted if D's 60 percent interest in partnership was a 60 percent interest in both the profits and capital of the partnership.

You contend that no change in ownership of the property should result because the beneficial use of the property was not transferred, only limited partnership interests that carried with it no management rights. You also state that no change in control occurred within the meaning of section 64, subdivision (c)(1) since "[o]wnership of a majority of the percentage interests of a limited partnership does not automatically convey control of the partnership as it does when someone acquires a majority of the voting stock of a corporation," and that your "concern with Section 64(c) is its underlying premise that in a limited partnership, control is based on the ownership percentage."

With respect to partnerships, section 64, subdivision (c)(1) states that a change in control occurs when a majority ownership interest in the partnership is obtained by an individual or other legal entity. As set forth above, a transfer of a majority ownership interest, and thus control, occurs when an individual or legal entity obtains more than 50 percent of the profit and capital interests in the partnership. (Rule 462.180, subd. (d)(1)(B); see also Annotation 220.0387.) The test for whether a change in control of a limited partnership occurred, therefore, is not the degree of management control transferred, but rather the amount of profits and capital interests transferred. (See Annotation 220.0391.) Thus, in applying section 64, subdivision (c)(1), it is not necessary to determine whether general partner or limited partner interests have transferred, but rather, whether an individual or legal entity has obtained more than 50 percent of the profits and capital interests in a partnership. (See Annotations 220.0383.)

You have not stated whether the 50 percent partnership transferred by M to D carried with it rights to the partnership profits and capital. If it did (and D already owned 10 percent of the partnership capital and profits) there was a change in control of the partnership within the meaning of section 64, subdivision (c)(1) and Rule 462.180, subdivision (d)(1)(B) and a change in ownership of all the real property owned by the partnership occurred.

Finally, the transfer of the partnership interests from M to D does not qualify for the parent-child exclusion. Section 63.1 excludes certain transfers of *real property* between parents and their children. Section 63.1, subdivision (c)(3) states that "real property" means "real property as defined in section 104. *Real property does not include any interest in a legal entity.*" (Emphasis added.) This could not be more clear. Because M transferred interests in a limited partnership to D, the transfer can not be excluded under section 63.1. (See Annotation 625.0180.)

You state in your letter, that:

The purported transfer of the Property would have the exact same result whether it occurred inside or outside the Partnership; however, had it happened outside the Partnership, the parent-child exclusion would have operated to avoid reassessment. To deny the parent-child exclusion in this matter, but allow it in the example in Section 2 of AB 47 as quoted above is inconsistent and is clearly not what the voters or the Legislature intended.

The language to which you refer, which is contained in an uncodified note to section 63.1 (note), states in relevant part that:

. . . 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 . . . legal entity to an eligible transferor or transferors, where the latter are the sole beneficial owners 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 owners or owners of the property, if the transfer between eligible transferors and eligible transferees satisfies the requirements of Section 63.1. (Emphasis added.)

Thus, this note can not reasonably be read to allow the transfer of an interest in a legal entity to qualify for the parent-child exclusion. Such a reading would violate the plain meaning of section 63.1, subdivision (c)(3). Instead, the note prevents the step transaction doctrine from being applied to collapse a specific series of steps, involving transfers between parents, their children, and legal entities owned by the parents and children, *when each step taken individually would qualify for an exclusion*. (See Annotations 625.0190 through 625.0196.) This ensures that the legislative intent to liberally construe the parent-child exclusion is met while, at the same time, ensuring that the exclusion is not expanded beyond what is statutorily allowed.

Finally, while it may be true, as you point out, that had the property been transferred outside of the partnership, it would have qualified for the parent-child exclusion, the fact remains that the property was not transferred outside of the partnership. This same argument was essentially made by the taxpayer in *Penner v. County of Santa Barbara* (1995) 37 Cal.App.4th 1672, 1679 (*Penner*) to which the court responded, the taxpayer ". . . must accept the tax consequences of [her] choice whether contemplated or not, [citations] and may not enjoy the

benefit of some other route [she] might have chosen to follow but did not." (*Ibid.*, citing *Commissioner v. Nat. Alfalfa Dehydrating* (1974) 417 U.S. 134, 149.)

The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Sincerely,



Richard S. Moon
Senior Tax Counsel

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cc:

Mr. David Gau	MIC:63
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70
Ms. Sue Blake	MIC:78
Mr. Tom Hudson	MIC:78