



# Memorandum

To : Mr. Verne Walton

Date February 4, 1988

From : Richard H. Ochsner *RHO*

Subject : Proposition 58: Combined Exclusions

This is in response to your request for written advice on the proper interpretation of that portion of Revenue and Taxation Code section 63.1(b)(2) dealing with an election of joint transferors to combine their separate \$1 million exclusions. You ask whether the provision authorizing the election may be interpreted in such a way as to permit the exclusion of a transfer from one of the transferors of an amount which exceeds the \$1 million limit. As discussed more fully below, I have concluded that while the matter is not free of doubt the answer is affirmative.

The \$1 million exclusion is authorized by a reference in Proposition 58, amending article XIII A, section 2, to "transfer of the first \$1,000,000 of the full cash value of all other real property between parents and their children, as defined by the Legislature." This language gives the Legislature authority to determine the contours of the \$1 million exclusion and suggests that it has broad discretion in this area.

In exercising the discretion granted by Proposition 58, the Legislature enacted subdivision (b)(2) of Revenue and Taxation Code section 63.1 to supply some detail as to the meaning of the \$1 million exclusion. Subdivision (b)(2) first provides that the exclusion applies separately to each eligible transferor with respect to transfers of real property on or after November 6, 1986, excluding the transferor's principal residence. It goes on to provide:

"In the case of any purchase or transfer subject to this paragraph involving two or more eligible transferors, the transferors may elect to combine their separate one million dollar (\$1,000,000) exclusions and, upon making that election, may jointly sell or transfer property with a full cash value of not more than the combined amount of their separate exclusions."

The question is whether the quoted language, particularly the language underlined, permits two or more eligible transferors who have co-ownership interests in a particular property to elect to combine their separate \$1 million exclusions and may jointly transfer property with a full cash value up to the amount of the combined exclusions without effecting a change in ownership even though the full cash value of the property interest transferred by one or more of the joint transferors exceeds \$1 million?

In considering this question, we need to keep in mind the possible circumstances in which the question could arise. The most typical situation, of course, is where a husband and wife, as parents, transfer property to a child or children. Obviously, if the interests of the two parents are not equal, they could be equalized by a transfer of a portion of the interest from one parent to the other without a change in ownership. That is not the case, however, where the parents have divorced. They still qualify as parents vis-a-vis the children but they are no longer spouses or eligible for the spousal exclusion. Actually, the number of persons who can qualify as a parent is much larger than one might think. For example, if the divorced parents remarry, then there are two step-parents in addition to the natural parents. Moreover, there might be a former step-parent who has since divorced the natural parent who retained the status of parent because that person adopted the child. If the child is married, then there is also a set of in-laws who qualify as parents. Two or more of the persons in this eligible group could jointly own varying interests in the property being jointly transferred to the child or children. Of course, where the transfers are from children to parents, there is an even larger potential group of eligible transferors who might jointly transfer property.

Reviewing the legislative history of section 63.1 provides little help in determining the legislative intent behind the joint exclusion language. The bill analyses in both the Assembly and the Senate Revenue and Taxation Committees merely state that "a husband and wife transferring community property would have a \$2,000,000 limit." During the course of the legislative development of these provisions, questions were raised as to the meaning of the \$1 million exclusion and whether it was \$1 million per person or per husband and wife. Apparently, the language of subdivision (b)(2) was designed to clarify these issues. The first sentence in the subdivision clarifies that each eligible transferor receives a full \$1 million exclusion. Thus, the question is what purpose is served

by the second sentence. Dave Doerr was the chief architect of these provisions. In discussing the joint transfer exclusion, Dave states that he does not believe they considered the question presented here. Apparently they were thinking in terms of the simpler husband and wife community property transfer situation. However, his reaction, like mine, was that the language adopted would grant the full combined exclusion even though the transfer from one of the parties exceeded the limit.

My conclusion is based upon the language of the provision which expresses a clear intent to allow an exclusion equivalent to the combined amounts of the separate exclusions of the electing transferors. While it is clear that the language does contain ambiguities which require interpretation, the intent to allow the full combined amount of the separate exclusions seems clear from the express language.

I say that some interpretation is necessary because the language states that the persons who make the election "may jointly sell or transfer property with a full cash value of not more than the combined amount of their separate exclusions." Obviously, the parties are free to sell or transfer property of any amount. I do not believe there was any intent to attempt to limit the amount of property that a transferor could sell or transfer. The language is intended to go to the amount of the exclusion to be applied rather than to create some limitation upon transfers of property.

Having made this interpretation, it nevertheless seems clear that the amount of the exclusion provided is "the combined amount of their separate exclusions." I don't believe this language can be limited by the language in the constitution referring to a \$1 million exclusion since the constitution gives authority to the Legislature to define that concept. While I recognize that there is room for differing opinions on this, a court presented with the question would most likely find that the election grants an exclusion to the full combined amount. Since it seems more likely that the courts would grant the full combined exclusion, I cannot recommend that we advise assessors to take a more conservative approach.

Obviously, this is another area which could benefit from clarification and should be discussed with the author of our clean-up legislation. There are some good arguments for allowing the full combined exemption. For example, without the election possibility, still-married parents can utilize the

interspousal exclusion to equalize their interests and maximize the benefits of the exclusion. This approach discriminates against parents who have subsequently divorced, however, and no longer have the interspousal exclusion available. Should the law discriminate against divorced parents in this way?

On the other hand, there are good arguments for limiting the combined exclusion because of the potential for abuse. Where one parent owns separate property with a full cash value of \$3 or \$4 million, multiple exclusions could be created by transferring small fractional interests, perhaps as small as 1/10th of 1 percent, to other eligible parent transferors. This method could create a joint exclusion large enough to exclude all of the property from change in ownership. Obviously, these abuses might be challenged on the theory that the transfers were shams or part of a step-transaction and should, therefore, be ignored. We know, however, that these defenses can be overcome through careful long range planning. Thus, where the property has great value, it may be very worthwhile to engage in such creative tax planning. In light of this potential for abuse, I would recommend that a limitation be placed on the joint exclusions.

The joint exclusion election creates other interpretative questions which are not answered by the legislation. For example, what is the effect of an election by two or more eligible transferors? Having elected to combine their exclusions to jointly transfer property are the exclusions thereafter forever joined? If the value of the property transferred under the election is less than the total of the combined exclusions, what happens to the excess exclusion? Can it apply thereafter only to joint transfers by the electing transferors or can any excess be utilized by one or other of the transferors in a single-party transfer? This is something else we need to consider in our clarifying legislation.

Your memo also asks about the potential use of joint tenancy interests as a means of increasing the potential combined total exclusion. You ask if A transfers his sole and separate property to A and B as joint tenants (a nonchange in ownership) and then A and B transfer the property to a qualified transferee, whether they could elect and receive a combined exclusion of \$2 million? I believe the correct answer is that since the transfer from A to A and B was not a change in ownership, we should treat the subsequent transfer as one from A to the eligible transferee and only a \$1 million exclusion would apply. Perhaps we also need to clarify this issue in the

clean-up bill since there is nothing express in the language of section 63.1 which would clearly require that result.

RHO:cb  
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cc: Mr. James J. Delaney  
Mr. Gordon P. Adelman  
Mr. Robert H. Gustafson  
Mr. Arnold Fong  
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August 22, 1996

Re: Change in Ownership - Transfer to Wife's Irrevocable  
Trust - Parent/Child Exclusion.

Dear Mr. :

This is in response to your letter of June 28, 1996, in which you request our opinion regarding the change in ownership consequences of the following hypothetical transaction involving an irrevocable trust:

1. Husband transfers Blackacre on his death to an irrevocable trust in which his Wife is the sole present income beneficiary for life and their Children hold the remainder interests. Wife also has the power to invade the principal for reasonable health, education, and support.
2. Upon the death of Wife, Children wish to apply Husband's one million (\$1 million) dollar parent/child exclusion to transfer of Blackacre and Wife's one million (\$1 million) dollar parent/child exclusion to other real property from Wife.

You believe that the first transfer of Blackacre to Wife through the irrevocable trust is excluded from change in ownership under the interspousal exclusion. You wish to know whether the second transfer of Blackacre upon Wife's death, to the Children would be eligible for the full \$1 million parent/child exclusion, since Children will apply Wife's \$1 million exclusion to other real property as well. You further believe that the issues involved here are similar to those described in a 9-page letter from one of our attorneys and you request a copy of that letter.

For the reasons hereinafter explained, we agree that the first transfer of Blackacre to the irrevocable trust for Wife is excluded from change in ownership under Revenue and Taxation Code Section 62(d), and that the second transfer of Blackacre upon Wife's death to the Children is eligible for the parent/child exclusion per Section 63.1, without reducing the amount of Wife's \$1 million exclusion for the transfer of other property to Children. To the best of our knowledge, the 9-page letter that you have requested on similar issues would appear to be the January 10, 1996, letter from Mr. Eric Eisenlauer, a copy of which is enclosed.

#### LAW AND ANALYSIS

##### **Step 1: Transfer to Irrevocable Trust for Wife is Excluded from Change in Ownership under Section 62(d).**

Revenue & 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."

However, among the exclusions from change in ownership is the provision of Section 62(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 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.

This statutory provision has been interpreted by subdivision (b) of Property Tax Rule 462.160 (18 California Code of Regulations, Section 462.160) which provides in pertinent part:

(2) Exceptions. A transfer to a trust is not a change in ownership upon the creation of or transfer to a trust if:

(1) Trustor-Transferor Beneficiary Trusts. The trustor-transferor is the sole present beneficiary of the trust; provided, however, a change in ownership of trust property does occur to the extent that persons other than the trustor-transferor are present beneficiaries of the trust.

(2) Revocable Trusts. The transfer of real property...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.

\* \* \*

(4) Interspousal Trusts. The exemption afforded interspousal transfers is applicable; provided however, a change in ownership of trust property does occur to the extent that persons other than the trustor-transferor's spouse are beneficiaries of the trust.

\* \* \*

(6) Other Trusts. the transfer is from one trust to another and meets the requirements of (1), (2), (3), (4), or (5).

Based on the foregoing provisions, Husband's transfer of Blackacre into an irrevocable trust upon his death, in which his Wife is the sole income beneficiary, does not constitute a change in ownership, since Wife, as the trustor-transferor's spouse, retains the sole present beneficial enjoyment of the trust property for as long as she lives. The assets of the trust are considered as beneficially owned by the Wife during her lifetime. Therefore, the first transfer of Blackacre fits squarely within Section 62(d) and Rule 462.160(b)(4).



**Step 2: Transfers Outright to Children Upon Wife's Death Excluded (up to first \$1 Million) per Section 63.1.**

The Legislature enacted Revenue and Taxation Code Section 63.1 to implement the Proposition 58 exclusion, which 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:

(1) The purchase or transfer of real property which is the principal residence of an eligible transferor in the case of a purchase or transfer between parents and their children.

(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.

(b) (1)...

(2) For purposes of paragraph (2) of subdivision (a), the one million dollar exclusion shall apply separately to each eligible transferor with respect to all purchases by and transfers to eligible transferees on and after November 6, 1986, of real property, other than the principal residence of that eligible transferor....

(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....

(5) "Eligible transferee" means a parent or child of an eligible transferor.

\* \* \*

(7) "Transfer" includes, and is not limited to, any 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.

Based on the foregoing, it is clear that a \$1 million exclusion is available for Blackacre from Husband and for other real property in the trust from Wife, as long as the transfers are made from "eligible transferors" to beneficiaries who qualify as "eligible transferees" under the above definitions. You have a two-fold concern, however, with regard to the exclusion in the instant case: (1) how many \$1 million exclusions would be applicable, and (2) what effect does the Wife's power of appointment have on the amount of each exclusion.

With regard to the number of exclusions available, we have taken the position that both the language and intent of Section 63.1(b)(2) allow a full \$1 million exclusion to each eligible transferor who has an ownership interest in property. (See Richard H. Ochsner Memorandum, February 4 1988, enclosed.) Thus, even though the Husband predeceases Wife, Husband and Wife each retain a separate \$1 million exclusion. Since Husband becomes an eligible transferor relative to his property interests (in Blackacre) when he dies, the remainder interests will become possessory (i.e., present beneficial interests in his children) upon Wife's death, making his \$1 million exclusion available when the irrevocable trust for her terminates.

As to the effect of the Wife's power of appointment on the amount of the exclusions, Wife has a special power to invade the trust principal. A special power of appointment, per Probate Code Section 611(b), is limited by an ascertainable standard relating to the person's health, education, support or maintenance, and is not a general power of appointment. The property over which an eligible transferor has a special power of appointment is not treated as if it were his or her own property. Moreover, where, as here, the donee of a special power of appointment is also the sole income beneficiary and has no the power to revoke the trust, there is no "transfer" of a present

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beneficial interest in the assets of the Trust to the children until wife dies. Thus, the real property (Blackacre) in trust that passes from the predeceased Husband at death should, in our view, be treated as have been transferred by the predeceased Husband and not the surviving spouse for purposes of the \$1 million exclusion, when it ultimately goes to the Children on the death of the surviving spouse.

Therefore, since the Step 2 transfer falls squarely within Section 63.1(a)(2), providing the Children file a timely claim with the assessor pursuant to the procedures set forth therein, Husband's transfer of Blackacre (up to the first \$1 million of full cash value) and Wife's transfer of other real property (up to the first \$1 million of full cash value) could be excluded from change in ownership for property tax purposes by the parent/child exclusion.

The views expressed in this letter are, of course, advisory only and are not binding upon the assessor of any county and we advise you to consult with the appropriate assessors regarding this matter. 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

KEC:ba  
Attachments

cc: Honorable  
County Assessor

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

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