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February 22, 2010

**Re: Request for Legal Opinion - Parent-Child Exclusion
Assignment No.: 09-243**

Dear Mr. _____ :

This is in response to your letter dated November 9, 2009, wherein you requested our opinion regarding the distribution of real property from a trust to one of the beneficiaries, subject to a loan on the property to equalize the distribution. As explained below, it is our opinion that the parent-child exclusion is available for the entire property under either of the situations you ask about so long as a parent-child exclusion claim form is properly filed and all other requirements are met.

Factual Background

According to your letter and the supporting documentation you provided, ("Rick") is the sole trustee of his deceased parents' trust and also a beneficiary of the trust along with his sister. The parents' trust became irrevocable upon the death of the surviving parent. The trust document stipulates that, after certain specific bequests, the trust remainder is to be divided equally between the two beneficiaries. The trust is the record owner of California real property located at _____ Street, _____, California (the property), which is part of the remainder estate. The trust document also gives Rick¹ the option to include the property in his share of the trust remainder, with the condition that he provides sufficient assets to his sister's share to equalize the distribution. Rick has chosen to exercise this option. The trustee is given the authority to borrow funds, using the property as security, to equalize the distribution. Rick would receive the property from the trust subject to the loan. You have requested our opinion on whether Rick, as a beneficiary receiving the property and acting on his individual behalf, may serve as co-borrower or guarantor of a loan taken out by the trust with the trustee as the primary borrower, and have the parent-child exclusion apply to the entire property.

¹ The trust document we were given for review indicates that the property would actually go to Rick and his wife as community property. However, this does not change our analysis, so for convenience we will refer to "Rick" as the sole recipient of the property.

Law and Analysis

Revenue and Taxation Code² 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." There is typically a change in ownership of all property interests that vest in persons other than the trustor when a revocable trust becomes irrevocable. (Rev. & Tax. Code, § 61, subd. (h).)

Therefore, there would be a change in ownership of the property at the death of the surviving parent unless an exclusion applies. In this case, it appears that the parent-child exclusion may apply. Section 63.1, which implements the parent-child and grandparent-grandchild exclusions, excludes from change in ownership the transfer, between parents and children, of any number of principal residences and the first \$1 million of full cash value of other real property. (Rev. & Tax. Code, § 63.1, subds. (a)(1) and (2).) The term "transfer" includes transfers from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust. (Rev. & Tax. Code, § 63.1, subd. (c)(9).) In this case, it appears that Rick's parents are eligible transferors and Rick is an eligible transferee and the exclusion will apply if all other criteria are met. The question is whether the entire property, or only the portion that comprises Rick's pro rata share of the trust remainder, is eligible for the parent-child exclusion.

When a trust document does not indicate a certain percentage interest that the beneficiaries have in each piece of property, but rather gives them an equal undivided interest in the whole of the trust estate (share and share alike), and allows non pro rata distributions, the trustee may allocate certain properties to some beneficiaries and not to others. As such, if there are sufficient trust assets to equalize the distributions to all other beneficiaries, a trustee may distribute real property to an eligible transferee and other assets to other beneficiaries and the transfer to the eligible transferee will be deemed directly from the trustor and entirely excluded from reassessment under section 63.1. However, to the extent that the value of the real property received exceeds the value of the beneficiary's share of the trust estate it will be considered a transfer from the other beneficiaries and subject to reassessment. (Letter to Assessors (LTA) 91/08).

To accomplish an equal distribution, the trustee may encumber the property with a loan so long as the loan proceeds are not provided by the beneficiary receiving the property. (Property Tax Annotation (Annot.) 625.0235.005.) In our view, serving as a co-borrower or guarantor of the loan is similar to providing the loan proceeds because a co-borrower or guarantor is liable for repayment of the loan if the trustee fails to make the loan payments. Thus, if this were the typical share-and-share-alike situation, then in our view if Rick as an individual served as a co-borrower or guarantor then the excess value of the property received over the value of his pro rata share would not be eligible for the parent-child exclusion.

In this case, however, although Rick and his sister are given equal interests in the trust remainder, what differentiates this situation from the typical share and share alike provision described above is the option for Rick to receive the entire property subject to payment by the trust to his sister of an equalizing amount, which amount is to be provided to the trust by Rick. A similar situation was discussed in Property Tax Annotation 625.0250, which bases its analysis

² All section references are to the Revenue and Taxation Code unless otherwise noted.

on the court's discussion in *Woodley v. Woodley* (1941) 47 Cal.App.2d 188 at page 191, as follows:

But we are satisfied that there is no trust involved, but that the rights of the parties rest upon an 'equitable charge.' The distinction between these relations is clearly drawn in Scott on Trusts, vol. 1, section 10, as follows: 'If a testator devises or bequeaths property subject to the payment of certain sums of money to third persons, he thereby creates an equitable charge, not a trust. An equitable charge is like a trust in that in each case the legal title to property is vested in one person and an equitable interest in the property is given to another. The interest which the equitable encumbrancer has, however, is different from the interest of a beneficiary of a trust. The equitable encumbrancer has only a security interest in the property; the beneficiary of a trust is, to the extent of his beneficial interest, the equitable owner of the trust property. If a devisee subject to an equitable charge fails to pay the equitable encumbrancer the sum to which he is entitled, the latter's remedy is a suit in equity to obtain a decree for the sale of the land to pay the charge; if a trustee fails to perform his duties under the trust, the remedy of the beneficiary is a suit in equity to compel specific performance or redress of the breach of trust.' (Emphasis added.)

In the typical share and share alike trust, each beneficiary has a beneficial ownership interest in each of the trust's assets, including each piece of real property. In this case, Rick's sister does not have a beneficial ownership interest in the property as a result of Rick's exercise of the option. Instead, her interest is in receiving an equalizing payment, which in our view is in the nature of a security interest created by an equitable charge. The nature of the sister's relationship to the property created by Rick's exercise of the option would appear to be that of an equitable encumbrancer. The effect of the equitable charge is that Rick receives the entire legal and beneficial ownership of the property from his parents, subject to a security interest in his sister of his payment to the trust of the equalizing amount. Thus, it is immaterial whether Rick as an individual acts as co-borrower or guarantor on the loan. In either case, the entire property would be eligible for the parent-child exclusion.

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,

/s/ Daniel Paul

Daniel Paul
Tax Counsel

DP:yg

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cc: Mr. David Gau MIC:63
Mr. Dean Kinnee MIC:64
Mr. Todd Gilman MIC:70