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July 13, 1999

In Re: **Change in Ownership – Death of a Partner;**
Partnership Dissolution under Section 64 (c)(2);
Sections 64 (a) and 62 (a)(2) – Step Transaction Doctrine.

Dear Mr. _____ :

This is in response to your letter of April 28, 1999, requesting our opinion concerning the application of the change in ownership exclusion under Revenue and Taxation Code Section 64 (c)(2) to the following fact pattern:

1. AB Partnership is a California general partnership formed in 1968 which holds various real properties. A owned 75% through his revocable living trust, and B owned 25% through his revocable living trust.
2. BA Partnership is also a California general partnership formed in 1968 holds other real properties. A owned 49% through his revocable living trust, and B owned 51% through his revocable living trust.
3. A died in 1998, and his partnership interests in both AB Partnership and in BA Partnership passed to the Trustee of A's Trust which became irrevocable on the date of his death.
4. In 1999, the Trustee for A's Trust proposed the following: A's Trustee will purchase B's interests (25%) in AB Partnership and in exchange, B will purchase A's Trust's (49%) interest in BA Partnership (with an appropriate amount of cash to equalize the values). Upon such acquisitions, both partnerships will dissolve by operation of law, and the property from each partnership will be distributed pro rata to the beneficiary(ies) of A's Trust (AB Partnership) and to B (BA Partnership).

Your question is whether the majority partner's acquisition of the minority partner's interest in each of the partnerships would be excluded from change in ownership under Section 64 (c) (2). The short answer to this question is "no," because a change in ownership of A's Partnership interests in both partnerships occurred on A's death when A's Trust became irrevocable and his partnership interests transferred to the beneficiary(ies) of A's Trust. Section 64 (c) (2) would apply only if the surviving partner (B) had acquired A's partnership interests on A's death. As hereinafter explained however, some exclusions relevant to partnership and trust transfers may apply, except for the application of the step transaction doctrine.

1. Date of Change in Ownership is Date A’s Trust Became Irrevocable and A’s Partnership Interests Transferred to his Beneficiary.

Under change in ownership law, transfers of interests in real property, including transfers of interests in legal entities holding real property, occur upon the date the trust becomes irrevocable, which is the date of death of the trustor/settlor of a revocable trust. Rule 462.260(d)(1) states that the date of change in ownership of real property in a revocable trust is as follows:

Revocable. The date the trust becomes irrevocable.

Example 1: A creates an inter vivos revocable trust that becomes irrevocable upon A’s death. “The date of change in ownership is the date of A’s death.”

When a trust is revocable, the trustor is considered to be the beneficial owner of the assets since the trustor has the power to revoke the trust. Section 62(d) recognizes this principle when it states that a change in ownership shall not include “any transfer by the trustor . . . into a trust for so long as . . . the trust is revocable. At the point when the trust becomes irrevocable, there is a change in ownership of all of the property owned by the trust (including partnership interests), since the trust beneficiary is considered the owner. (Section 61 (g).) The trustee is never viewed as the owner of the trust property, even though the trustee has legal title and authority to sell the trust property.¹ (See Annotated Letter No. 220.0761, 7/14/80, copy attached).

Thus, there was a change in ownership of all the property (including any partnership interests) held in A’s Trust on the date of A’s death because his trust became irrevocable and A’s beneficiary(ies) became the owners of the trust property. Some exclusions apply, however.

2. Section 64 (c)(2) – Excludes Acquisition of a Minority Partner’s Interest by A Majority Partner, Causing Partnership Dissolution, but is Not Applicable here.

In *Zapara v. Orange County* (1994) 26 Cal.App.4th 464, the court held that the dissolution of a partnership caused by the “buy-out” of the **minority** partner’s interests by the majority partner, who owned 73% of the partnership interests, was a change in ownership. The court’s reasoning was that because of the dissolution by operation of law (automatic termination of a partnership with only one partner) the majority partner became the owner of 100% of the property, which was not proportionate to his 73% interests in the partnership. This decision contradicted the long-standing interpretation of Board staff, that transfers of minority interests to the majority partner, whether such transfers occurred by reason of buy-out or death, were excluded from change in ownership under Section 64(a).²

In order to reverse this decision, the Board of Equalization sponsored legislation to exclude transfers of minority partnership interests to the majority partner, even if the partnership dissolves when the

¹ Under well established trust principles, if the trustor retains the power of revocation and/or is the sole present income beneficiary, the interest he retains is considered "substantially equivalent in value" to the fee. On the other hand, once the power of revocation ceases, the interests of the trust beneficiaries “vest” (transfer), and their interests are considered "substantially equivalent in value" to the fee (See Report of the Task Force on Property Tax Administration to Assembly Revenue and Taxation Committee, January 22, 1979, p.43.)

² Section 64(a) exclusion now states in part:
“Except as provided in subdivision (h) of Section 61 and subdivisions (c) and (d) of this section, the purchase or transfer of ownership interests in legal entities, ... shall not be deemed to constitute a transfer of the real property of the legal entity. This subdivision is applicable to the purchase or transfer of ownership interests in a partnership without regard to whether it is a continuing or dissolved partnership.”

majority partner acquires 100%. Enacted by Section 40 of Stats.1995, Ch.497 and codified by statute in Section 64 (c)(2), it states:

(2) On or after January 1, 1996, when an owner of a majority ownership interest in any partnership obtains all of the remaining ownership interests in that partnership..., the purchase or transfer of the minority interests, subject to the appropriate application of the step-transaction doctrine, shall not be a change in ownership of the real property owned by the partnership.³

Thus, minority interest transfers to the majority partner, by reason of purchase or death, do not constitute a change in control or change in ownership, even if the result is partnership dissolution (because the majority partner is the sole partner). The premise is that since the majority partner owns a controlling interest (more than 50%), he already owned and controlled the legal entity that holds the property; his acquisition of the remaining minority interests does not constitute a transfer rising to the level of change in ownership per Section 60 and is consistent with the exclusion in Section 64 (a).

There are two reasons why the exclusion in Section 64 (c)(2) does not apply to these facts. First, the partnership interests that transferred upon A's death passed to his trust beneficiary(ies), not to the surviving partner (B). Secondly, unless otherwise stated in the respective partnership agreements, both AB Partnership and BA Partnership already dissolved by operation of law on A's death with A owning the majority (73%) in AB Partnership. The change in ownership consequences of A's partnership interests upon his death could not fall within the Section 64 (c)(2) exclusion, since A's Trust did not direct that his interests must transfer directly to B.

3. Other Exclusions Applicable to Trust Transfers of Partnership Interests on the Death of a Partner.

Under Rule 462.160(b)(2), there are two exclusions stating that a change in ownership does not occur when a trust becomes irrevocable: 1) the trustor-transferor remains or becomes the sole present beneficiary; or 2) the transfer is otherwise excluded from change in ownership (e.g., under the interspousal, parent-child, or other exclusions). In regard to legal entity interests held in trust, Rule 462.160 expressly states in (b)(1)(C) that the transfer of legal entity interests into a trust is not a change in ownership, as long as the trustors-transferors are or will be the sole present beneficiaries of the trust, or the trust is revocable. The same provision also states however, that "...a change in ownership of the real property held by the legal entity does occur if Revenue and Taxation Code Section 61 (i), 64 (c), or 64 (d) applies, because the change in ownership laws governing interests in legal entities are applicable regardless of whether such interests are held by a trust." Example 4 in Rule 462.160 sets forth a situation somewhat similar to the one you describe:

"Example 4. Husband and Wife, partners in HW Partnership who are not original coowners, transfer 70 percent of their partnership interests to HW Irrevocable Trust and name their four children as the present beneficiaries of the trust with equal shares. Husband and Wife do not retain the reversion. Under Revenue and Taxation Code Section 64 (a), the transfer of partnership interests to HW Irrevocable Trust is excluded from change in ownership because no person or entity obtains a majority ownership interest in the HW Partnership."

³ Both Section 64(a) and Section 64(c) were amended by Board-sponsored legislation intended to reverse the holding of *Zapara v. Orange County* (1994) 26 Cal.App.4th 464, involving the majority partner's buy-out of the minority partner.

Although we have not been provided a copy of A's Trust indicating the identity of his beneficiary(ies), the foregoing exclusions may apply as follows:

- a. Transfer of A's minority (49%) interest in the BA Partnership to his beneficiary(ies), was excluded from change in ownership under Section 64 (a), since the total partnership interests transferred did not exceed 50 percent. Section 64 (a) applies even if the BA Partnership agreement allowed for its continuation upon the death of the partner with A's beneficiaries taking his place.
- b. Transfer of A's majority (75%) interest the AB Partnership to his beneficiary(ies) was a change in control under Section 64 (c) (1), since the total partnership interests transferred exceeded 50 percent. The only available exclusions are Section 63 and Section 64 (a). The interspousal exclusion in Section 63 would exclude it from change in control, if A's Trust named his spouse as the sole present beneficiary and she received his 75% partnership interest.⁴ On the other hand, the exclusion in Section 64 (a) would apply if A's Trust named two or more persons as the sole present beneficiaries and neither one acquired more than 50% of the total of AB Partnership interests. (i.e., if each one of A's beneficiaries received half of A's 75% interest in AB Partnership, the transfer to them upon A's death would be excluded under Section 64 (a).)

4. Consequences are the Same if Partnerships Continued (unless first dissolved).

Although we have not been provided a copy of the partnership agreements, we have assumed for purposes of this analysis that when A died there was a dissolution of both partnerships under Corporations Code section 16801(2). Thus, when A's beneficiary(ies) succeeded to his partnership interests, they acquired interests in partnerships technically dissolved on the date of his death. We further assume that B and A's beneficiary(ies) did not reach a new agreement to continue the partnership within 90 days after A's death. The change in ownership consequences stated above thereby assume that A's beneficiary(ies) did not become partners or continue the partnerships other than for purposes of winding up. Though dissolved, the partnerships each retained their existence as a "separate entity."⁵ Any proposed reallocation of the partners' "interests" however, can result in a change in ownership as discussed below.

If the partnership agreements did provide for continuation, in that the beneficiary(ies) of a deceased partner would become a partner in his place without a dissolution, the change in ownership consequences would be the same: 1) transfer of A's minority (49%) interest in BA Partnership to his beneficiary(ies), would be excluded under Section 64 (a), since the total partnership interests transferred did not exceed 50 percent, and 2) transfer of A's majority (75%) interest AB Partnership to his beneficiary(ies) (new partner(s)), would be a change in control under Section 64 (c) (1), unless excluded per Section 63 or Section 64 (a).

⁴ As interpreted in Rule 462.220(b) the interspousal exclusion applies to "transfers of ownership interests in legal entities resulting in one spouse obtaining control as defined in Section 64 (c)." In Example 1 in subdivision (b), where one spouse receives from the other spouse the majority of the interests in a partnership (more than 50%), there is no change in ownership or control of the partnership.

⁵ The basic concept of all legislation on change in ownership was to treat partnerships, corporations, and other legal entities under the "separate entity theory" as opposed to the "aggregate" or "ultimate ownership" theory. (Report of Task Force to Assembly Revenue and Taxation Committee, Chairman Willie Brown, 1979, pp.45-47.) While certain exceptions were made (Sections 64(a), 64(c), and 62(a)(2)), as a whole the provisions adopted gave affect to the general laws of the state that endow partnerships and corporations with an "identity" separate from its owners.

The change in ownership consequences would be different only if 1) the partnership agreements did not provide for continuation on a partner's death, and 2) the partnerships dissolved after A's death and the 90-day dissociation, and 3) A's beneficiary(ies) and B decided to create new partnerships. When a partnership is dissolved by death or otherwise, a continuation of a partnership relationship by the remaining partners or by additional partners is considered a new partnership. (See *Ellingson v. Walsh, O'Connor & Barneson* (1940) 15 Cal.2d, 673, 676 and 30 Ops. Cal. Atty. Gen. 238, 239 (1957).) Thus, if after A's death and the 90-day dissociation period, B and A's beneficiary(ies) decided to transact the partnerships' business, new partnerships came into being. There was, in legal effect, a transfer of the partnerships' property from the old partnerships to the new partnerships, constituting a change in ownership of both partnerships under section 61(j) and Rule 462.180 (e) as entity to entity transfers, resulting in reappraisal of 100% of the partnerships' real properties.⁶ (See also Letter to County Assessors dated October 11, 1979 (No. 79/175) examples 14-16, copy enclosed.)

5. Proposed Transfers of Partnership Interests followed by Pro Rata Distribution of Property: Exclusions Available but Step Transaction Doctrine May Apply.

The proposal here actually involves two sets of transfers. First, some of the partnership interests will be sold and/or exchanged between A's beneficiary(ies) and B, in order that the majority partner in AB Partnership, A's beneficiary(ies), will own 100% of the partnership interests, and the majority partner in BA Partnership, B, will own 100% of those partnership interests. Even though the partnerships were dissolved and winding up, until liquidation is completed, transfers of partnership interests held by the partners, former partners, or their beneficiaries can result in changes in ownership.⁷

In the second set of transfers, there is a liquidation of both partnerships. AB Partnership will distribute 100% of its property to A's beneficiary(ies), and BA Partnership will distribute 100% of its property to B. Thus, former partner B and beneficiary(ies) of the deceased partner A will have acquired real property in exchange for their respective partnership interests.

The exclusion applicable to the first set of proposed transfers is Section 64 (a). Even if the partnerships are dissolved, the transfer of minority interests to the former partner or beneficiary(ies) who hold the majority interests, whether such transfers occurred by reason of buy-out or death, are excluded from change in ownership under Section 64(a). The transfer of B's 25% in AB Partnership to A's beneficiary(ies) is excluded under Section 64 (a) and the transfer of A's beneficiary(ies)' 49% in BA Partnership to B is excluded under Section 64 (a).

The exclusion applicable to the second set of proposed transfers is Section 62 (a)(2). All of the real property from AB Partnership will be transferred to A's beneficiary(ies) who now own 100 percent of its partnership interests, and all of the real property from BA Partnership will be transferred to B who now owns 100 percent of the partnership interests. These fall squarely with the Section 62 (a)(2) exclusion as proportional interest transfers between individuals and a legal entity, which result solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, in each and every piece of real property remain the same after the transfer.

⁶ The only possible exclusion would be under section 62(a)(2). However, it does not apply since the partners' proportional ownership interests in the old partnerships before dissolution are different than such ownership interests in the new partnerships after dissolution.

⁷Section 480.1 requires the filing of a change in ownership statement with the State Board of Equalization whenever there is a change in control of any partnership or legal entity.

Based on the foregoing, it is possible that the step transaction doctrine may apply to collapse the first and second transfers together as one step intended to avoid a change in ownership. Where two partners each owned a specific percentage of partnership interests before the transaction, they would need to own the same respective percentage of the real property distributed from the partnership to themselves following the transaction, in order to apply the exclusion in Section 62 (a)(2). If one or more other steps are undertaken in order to complete this transfer under Section 62 (a)(2) however, then the application of the "step transaction doctrine" becomes a relevant consideration .

The "step transaction doctrine" has been applied to property tax transfers when unnecessary steps are taken merely to circumvent the intent of the change in ownership statutes. In such case, the "substance of the transaction, rather than the form" will determine if a change in ownership has actually occurred. In Shuwa Investment Corp. v. County of Los Angeles (1991) 1 Cal. App. 4th 1635), the court set forth three possible tests for the application of the step transaction doctrine. The "end result test" looks at the various steps as component parts of a single transaction. The "interdependence test" focuses on whether one step would have been taken without any of the other steps apart from the parties' intent to utilize an exclusion. The final test, known as the "binding commitment test," looks at whether the structure of the transactions is such that taking the first step, in effect, constitutes a binding commitment to follow through with the entire transaction, e.g., the parties agree to specified transfers in a certain chronological order, beginning with the first, in order to complete the entire transaction.

The proposed transfers here indicate that there has been a determination by the surviving partner B and A's beneficiary(ies) that both partnerships will go out of business, and that B and A's beneficiary(ies) will each become the sole owner of particular real property. To accomplish this result by the most direct means possible, they could simply convey the property owned by each partnership to only one partner, i.e., AB Partnership transfers its property to A's beneficiary(ies) and BA Partnership transfers its property to B. The consequence of this would be a 100% change in ownership of the property in each partnership, as the real property interests transferred from each partnership would not be proportionate to the partnership interests held by the individuals. (Section 61 (j).)

Thus, when a less direct method of structuring this transaction is used, such as transferring partnership interests to each of the majority partners first, it might be concluded that the parties intend to avoid reappraisal of the partnerships' properties. It appears that the parties are undertaking an **extra step** to effect the transfer to from the partnerships to themselves as sole owners, in order to use the Section 62(a)(2) exclusion.⁸

In Munkdale v. Giannini (1995) 35 CA4th 1104, the court held that there was a change in ownership of the real property when a dissolved partnership issued deeds transferring five parcels of real property (100%) to each partner as the sole owner⁹. The court noted that had the parties structured their transaction differently, utilizing two steps in order to achieve proportionality, the assessor would have been justified in applying the step transaction doctrine, because the two step would have been component

⁸ The fact that there may be independent business reasons for the parties taking the various steps does not prevent the application of the step transaction doctrine. In McMillin-BCED/Miramar Ranch North v. County of San Diego (1995) 32 Cal.App.4th 545, the court held that a reasonable interpretation of the facts indicated that the "interdependence test" was met; the steps were so interdependent that the legal relationships created by one transaction would have been fruitless without a completion of the entire series. Neither the "end result test" nor the "binding commitment test" were held to lead to a change in ownership conclusion, since both of these tests require the same parties to have been pursuing a related intent throughout all of the steps of the transaction.

⁹ No exclusion was applicable because their interests in the real property after the transfer from the partnership to the individuals were not the same as their respective partnership interests before the transfer. Prior to the transfer each partner held a 50% interest in each of the ten parcels owned by the partnership. Following the transfer, each partner owned 100% of five of the parcels and 0% in the other five parcels. Therefore, the proportionality requirement for the exclusion under Section 62 (a)(2) was not met.

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parts of a single transaction , the original intent and ultimate result of which were for the individual partners to acquire 100 percent of particular real property from the partnership. (pp. 1111-1113.)

If it appears to the assessor upon an examination of all the facts that the parties in the instant case have the same related purpose from the beginning and that at least one of the three tests are satisfied, then the step transaction doctrine may be applied. In such event, all of the property distributed from both partnerships would be subject to change in ownership and reappraisal per Section 61 (j).

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

Sincerely,

/s/ Kristine Cazadd

Kristine Cazadd
Senior Tax Counsel

property/precedent/prtnrshp/99/09kec
KEC:lg
Attachments

cc:

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