

220.0667 Step Transaction. Judicial decisions have indicated that it is proper to apply the substance over form or step transaction doctrine to property transfers that accomplish a change in ownership in multiple steps in an attempt to avoid reappraisal. The doctrine is applicable even if the various steps accomplish a business purpose other than avoidance of increased taxes.

The exception to the general rule is found in the legislative intent language of section 2 of Chapter 48 of the Statutes of 1987 (Revenue and Taxation Code section 63.1), which provides, in substance, that the parent/child exclusion applies to transfers by eligible transferors to eligible transferees even if such transfers are immediately followed by a transfer to a corporation, partnership, trust or other legal entity if the transferee(s) is/are the sole owner(s) of the entity. The Board's legal staff is of the opinion the same result should follow when an eligible transferor's parents or children also own interests in the entity. Subsequent transfers of ownership interests among the children or to non-eligible transferees would constitute a change in ownership if one person or entity obtained a majority interest in the entity or if more than 50 percent of the total ownership interests were transferred. C 4/5/88.



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April 5, 1988

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Dear Mr. Delaney:

This is in response to your letter of February 24, 1988 to Mr. James J. Delaney in which you request our opinion with respect to the "change in ownership" implications of the proposed methods of forming a family limited partnership outlined in your letter.

The first method proposed involves the situation in which the parents form a partnership ostensibly named a limited partnership although by its terms the parents (neither of whom is a limited partner) retain ownership of 100 percent of the real property transferred to the partnership. (We assume you mean that the partnership owns the real property and the parents retain 100 percent of the units of ownership of the partnership.) Subsequently, the parents give the children units representing legal interests in the partnership. The partnership provides by its terms that the children receive no legal or equitable interests in the partnership until units are received and then only to the extent of the units transferred. The certificate of limited partnership may be recorded either before or after the transfer of units.

This method of forming a family limited partnership was addressed in Mr. Delaney's letter to you of March 23, 1987 as follows:

"It is our further opinion, however, that at such time as gifts of partnership units are made to limited partners, the limited partnership will come into existence and a transfer of the real property to the limited partnership constituting a change in ownership will be deemed to have occurred. Please disregard any prior opinions to the contrary from our office.

"Moreover, if and when gifts of partnership units are made to the ~~Kishi~~ children, we believe the step-transaction doctrine would be a [sic] applicable unless it were shown that there was

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a valid business purpose (other than tax avoidance) for delaying the transfer of partnership units to the limited partners. If the step-transaction doctrine is applicable, it is our opinion that a change in ownership occurred when the real property was transferred in June 1985 rather than at such time partnership units are transferred to the limited partners. In that event, escape assessments would be required."

The next method of forming a family limited partnership outlined in your letter is one in which the parents transfer real estate they own equally to a general partnership formed in which they are equal partners. Subsequently, the parents transfer up to 50 percent of the partnership interests (whether or not represented by units) to their children or grandchildren and amend the partnership agreement to provide for coverage by the California Revised Limited partnership Act protecting the children and grandchildren as limited partners from general liability related to the affairs of the partnership. A certificate of limited partnership would then be filed.

The first step of the foregoing transaction would be excluded from change in ownership under Revenue and Taxation Code* section 62(a)(2) since the proportionate ownership interests of the parents in the real property remains the same after the transfer as it was before the transfer.

We believe the next steps, i.e., transferring partnership interests and converting to a limited partnership could subject the parties to the same risks of reappraisal mentioned above with respect to the first proposed method of creating a family limited partnership.

You argue that transferring units has a valid business purpose, i.e., shifting appreciation in assets while retaining control of the business, and that it is not a tax avoidance transaction and thus the step-transaction doctrine is not applicable.

We would first question your assertion that a transaction intended to shift appreciation in the value of assets is not a tax avoidance transaction when the obvious effect is to reduce the value of the estates of the transferors for purposes of federal estate tax. Moreover, assuming arguendo that transferring partnership interests has a valid business purpose, the step-transaction doctrine may still be applicable in our opinion. As we see it, the question is what business purpose exists for first forming a general partnership as one step in the process of creating a limited partnership when the

*All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

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intent from the outset was to create a limited partnership. Since creating a limited partnership initially would have resulted in a change in ownership, it appears to us that the step of first creating a general partnership has no purpose other than the avoidance of reappraisal and could be properly ignored or collapsed under the step-transaction doctrine.

You also take the position that amending a general partnership to conform with the California Revised Limited Partnership Act does not create a new entity. If that is true, such an amendment would not result in a change in ownership under section 61(i), i.e., a transfer from one entity (the general partnership) to another entity (the limited partnership).

We have taken the position, however, as has at least one county assessor, that such an amendment does result in the creation of a new entity and a change in ownership under section 61(i). Accordingly, this alternative, as well as the first one, could, if implemented, result in reappraisal in our view.

It appears to us that from a property tax standpoint, the best alternative is the last one outlined in your letter. Under that scenario, the parents deed to their children an interest in the real property and the parents and children then form a limited partnership in which their ownership interests are in the same proportion as their interests in the real property were before the transfer of real property to the limited partnership. As indicated in your letter, the transfers from parents to children would be excluded from change in ownership under section 63.1 (to the extent the full cash value limitation is not exceeded) and the subsequent transfer of real property from the parents and children to the limited partnership would be excluded under section 62(a)(2). With respect to whether the step-transaction doctrine should be applied at this point, section 2 of Chapter 48 of the Statutes of 1987 (AB 47) provides in relevant part:

"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. . . . 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 . . . if the

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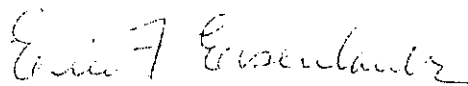
transfer between eligible transferors and eligible transferees satisfies the requirements of Section 63.1 Except as provided herein, nothing in this Section shall be construed as an expression of intent on the part of the Legislature disapproving in principle the appropriate application of the substance-over-form or step-transaction doctrine."

Although the foregoing language specifies that the step-transaction doctrine would not be applicable where the eligible transferees are the sole owners of the entity, we are of the opinion that a liberal construction of section 63.1 would preclude the application of the step-transaction doctrine under the facts of your last alternative, i.e., where the eligible transferees own part of the limited partnership and the eligible transferors own the balance of the limited partnership. Subsequent transfers of partnership interests would not constitute a change in ownership of the partnership property unless one person or entity obtained a majority ownership interest in the partnership or unless partnership interests representing cumulatively more than 50 percent of the total interests in the partnership were transferred by any of the parents or children in one or more transactions (section 64(a), (c) and (d)).

The views expressed in this letter are, of course, advisory only and are not binding upon the assessor of any county. You may wish to consult the appropriate assessor in order to confirm that the described property will be assessed in a manner consistent with the conclusion stated above.

If you have any further questions regarding this matter, please let us know.

Very truly yours,


Eric F. Eisenlauer
Tax Counsel

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