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January 3, 1990

Mr. [Name] Esq.,
[Address]
[City, State, Zip]

Dear [Name] :

This is in response to your letter of December 4 relating to the step transaction doctrine.

Your letter states that a partnership was formed in 1968 for the purpose of purchasing real estate. A parcel was purchased with contributions from partners in the following percentages:

Able	40%
Brown	20%
Cox	15%
Damon	15%
Easy	5%
Fox	5%
TOTAL	100%

The parcel remained in the partnership ownership without any transfers among the partners until 1987.

It was decided in 1987 to dissolve the partnership because of a general dissatisfaction with a number of the terms of the partnership agreement (management provisions, withdrawal provisions and debt provisions); one partner was leaving the area and did not wish to be involved any longer; one partner was retiring from an association with other partners; and one partner wanted to bring his children into the partnership over the objections of the other partners. The partnership was dissolved and the property distributed to the six individual partners as tenants in common. (Although not stated, I understand that the partners retained the same percentage interests as tenants in common as their percentage interests in the partnership.) Thereafter, the partners transferred tenant in common interests among themselves. Although your letter indicates that the total interests transferred was 37-1/3%, the information as to the ultimate ownership indicates that a total of 45% was transferred.

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January 3, 1990

That is, ..., on transferred interests totaling 45% to Able (20%), and Easy (25%). The resulting ownership was:

Able	60%
Easy	30%
Brown	1.667%
Cox	1.667%
Damon	1.667%
Fox	<u>5%</u>

TOTAL 100%

As I understand it from our telephone conversation, the Los Angeles County Assessor has applied a step transaction analysis and concluded that 100% of the property transferred from the partnership to the tenants in common should be reappraised and that an assessment appeal hearing is now pending. Your letter states that you feel that the step transaction doctrine is not applicable here because there were sound business purposes for the form of the transaction and you ask whether we agree that only 37-1/3% of the property should be reappraised. You also state that you believe that the Board's tax counsel letter ruling of December 24, 1981 on the subject of a step transaction is not controlling in this situation.

Attached is a copy of my memo to our property tax attorneys setting forth a statement of the step transaction doctrine as I understand it. It states that where a taxpayer utilizes a series of transfers or steps to effect a transfer which might otherwise have been accomplished by fewer transfers or steps, we recommend that any steps in the transaction be disregarded if the county assessor concludes that they are not supported by a business purpose other than avoiding higher property taxes. Whether the doctrine applies in any given situation is a question of fact which, in the first instance, must be determined by the county assessor and, ultimately, by the Assessment Appeals Board if the assessor's determination is challenged.

From our discussion, I understand that the assessor's position is based upon the conclusion that the substance of the subject transaction was that there was first a transfer of interests among the partners such that Able's partnership interest increased from 40% to 60% thus giving him control of the partnership. Under Revenue and Taxation Code section 64(c), this would result in a change in ownership of all of the partnership property. We believe that this interpretation is a misapplication of the step transaction doctrine. While the doctrine permits nonessential steps to be disregarded, it does not permit the assessor to change the order or character of the steps. Obviously, the actual

January 3, 1990

transaction described did not involve a transfer of partnership interests and such a transfer cannot be inferred from the step transaction doctrine. Thus, we conclude that in a transaction like the one described above, the step transaction doctrine would not support the conclusion that there was a change in ownership under Revenue and Taxation Code section 64(c) of all of the partnership property.

As I also discussed with you, however, it is possible to properly apply the step transaction doctrine to a transaction like the one described in your letter to reach the conclusion that all of the property transferred from the partnership to the tenants in common is subject to reappraisal. The type of transaction we refer to is where property is first transferred from a partnership to the partners with the partners retaining the same percentage interest as held in the partnership. Such a transfer would ordinarily be excluded from change in ownership by Revenue and Taxation Code section 62(a)(2) as a change in the method of holding title without a change in proportional ownership interests. The second step is then a transfer of some or all of the tenant in common interests. If the assessor concluded that the first step was not supported by a business purpose other than avoiding higher property taxes, the assessor would be entitled to treat the transaction as, in substance, a transfer of the property from the partnership to the ultimate owners in their final ownership shares. Since those interests would not be in proportion to the original partnership ownership shares, the transfer would not qualify for exclusion under section 62(a)(2) and the transfer of property would be a 100% change in ownership under Revenue and Taxation Code section 61(i).

As indicated above, the question of whether the step transaction doctrine should apply to the transfers described in your letter is a question of fact which must be determined by the assessor and, ultimately, by the Assessment Appeals Board. Although it appears, from the information you have provided, that one could reasonably conclude that the steps of the transaction you have described are supported by business purposes other than avoiding higher property taxes, I have not reached any conclusion as to that issue. Thus, we have not attempted to determine whether the full reappraisal of your client's property was appropriate.

I would agree, however, with your observation that the Board's legal counsel ruling, dated December 24, 1981, should not be considered controlling for purposes of determining whether or not the step transaction doctrine is properly applicable to your client's transaction. Whether or not that doctrine applies in any given situation is a question of fact which must be determined on a case-by-case basis. Thus, a determination based on one set of

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facts should not be considered precedent in another case where the facts may be totally different.

As you know, the views expressed herein are advisory only. They are not binding upon the assessor of any county or upon an assessment appeals board or county board of equalization.

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Very truly yours,

[Handwritten signature]

Assistant Chief Counsel

RHO:cb
2294D

cc: Mr. [unclear]
Or [unclear]

Mr. [unclear] y
Mr. [unclear]
Mr. A



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E. L. SORENSEN, JR.
Executive Director

May 6, 1997

The Honorable _____

Attn: _____

Re: Ventures Change in Ownership - Transfer upon
Dissolution of Partnership.

Dear _____

This is in response to your letter of March 13, 1997, in which you request our opinion concerning the change in ownership consequences of the facts described in the following transaction:

1. _____ Ventures, Bakersfield (hereinafter "Ventures"), a general partnership, was formed in March 1985 by its two partners: "KT," composed of the _____, Ltd. ("Group") and _____, ("Taylor") functioning as one partner, and "Corp," formally known as _____ Corp. The purpose of Ventures was the acquisition, ownership, development, management and operation of certain portions of a shopping center in Bakersfield.

2. Pursuant to the "*General Partnership Agreement of _____ Ventures: Bakersfield,*" (hereinafter, "Partnership Agreement") paragraph 6, KT agreed to contribute all of that property known as the "Bakersfield _____ Store (hereinafter "Store parcel," _____) to the Partnership, free and clear of any liens, at a value not to exceed \$3,700,000. Under paragraph 9, each partner would hold a 50% interest in the Store parcel, and Corp's contribution, in exchange for such interest, was the execution of, and obligation to a 40-year lease of the Store parcel with the rents constituting Corp's payment of consideration to Ventures. (Paragraphs 7 and 10.) Ventures subsequently acquired five additional parcels in or around the shopping center, of which only one, the original Store parcel is subject to dispute here.

3. On 8/23/94, KT and Corp executed the *Dissolution Agreement of Ventures* ("Dissolution Agreement"), authorizing the partnership dissolution and the prorata distribution to each of their respective interests in all land and improvements owned by Ventures. Pursuant to

paragraphs 1 through 6, Ventures liquidated the partners' interests, in part, by distributing a 71.13% tenancy-in-common interest to Corp and a 28.87% tenancy-in-common interest to KT in the Store parcel. The Dissolution Agreement, paragraph 2, indicates that this proration equitably accounted for the partnership income and liabilities to each partner relative to their respective 50% ownership interests, taking into consideration the fact that Corp was primarily responsible for Ventures' share of the outstanding balance on the \$3,139,164 loan against the property. For purposes of this analysis, we consider KT and Corp to have 50% ownership interests.

4. On the same date, 8/23/94, the parties executed a *Purchase and Sale Agreement and Joint Escrow Instructions*, ("Purchase and Sale Agreement") in which the former members of KT, Group and Taylor ("Sellers"), agreed to sell their respective tenancy in common interests in the Store parcel (as well as other parcels) to Corp ("Buyer"). The consideration was tendered, the grant deeds transferring title to Corp were delivered, and escrow was closed on or about this date, 8/23/94. The Dissolution Agreement was conditioned upon and only effective with the Purchase and Sale Agreement as stated in paragraph 4 of the Dissolution Agreement.

5. Ventures filed a preliminary change in ownership report on or about the date of the distribution and close of escrow, stating that the transfer was "from limited partnership to partner" and that the "Seller and Buyer are comprised of the same parties with the same proportionate interests."

You believe that as the result of the foregoing liquidation of Ventures and purchase of the former partners' interests in the Store parcel by Corp, there was a 100% change in ownership, and have reappraised the property accordingly. Corp has challenged your conclusion, claiming that because it owned 50% of the interests in Ventures prior to the dissolution, there was only a 50% change in ownership when its acquired 100% of the Corp parcel. For the reasons hereinafter explained, we believe that your conclusion is correct. The 8/23/94 distribution from Ventures and simultaneous sale of the other partners' interests in the Store parcel to Corp constituted a 100% change in ownership of the real property transferred under Revenue and Taxation Code Section 61(i) and the application of the step transaction doctrine.

LAW AND ANALYSIS

As you are aware, Revenue and 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." Section 61(i) states that a change in ownership, as defined in Section 60, includes, but is not limited to:

- (i) The transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner, or any other person."

The exclusion to the foregoing change in ownership, which has been asserted as relevant by Corp, is found in Section 62(a)(2), and provides that a change in ownership shall not include:

* * *

Any transfer between an individual or individuals and a legal entity or between legal entities, such as a cotenancy to a partnership, a partnership to a corporation, or a trust to a cotenancy, which results 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, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer. The provisions of this paragraph shall not apply to transfers also excluded from change in ownership under the provisions of subdivision (b) of Section 64.

Property Tax Rule 462.180 (a) and (b)(2) is to the same effect and provides that transfers of real property between separate legal entities or by an individual(s) to a legal entity (or vice versa), which result solely in a change in the method of holding title and in which the proportional ownership interests in the property remain the same after the transfer are excluded from change in ownership.

Thus, under these statutes and rules, where two individual partners were equal 50% owners of a partnership which owned real property before the transaction, they would need to be the equal 50% owners 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, however, one or more other steps are undertaken to complete the transaction, then the application of the "step transaction doctrine" becomes a relevant consideration, and an unexcluded change in ownership may have occurred.

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. (Shuwa Investment Corp. v. County of Los Angeles (1991) 1 Cal. App. 4th 1635).

In Shuwa, 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.

Reassessment Upon Change in Ownership - Step Transaction Doctrine Applicable.

Any determination regarding the application of the step transaction doctrine is ultimately based upon a thorough understanding of all the surrounding facts and therefore ultimately rests

with the assessor evaluating the situation. For purposes of this analysis, the various documents submitted to us would indicate that the following transfers occurred in regard to the Store parcel, and that the end result of the two 8/23/94 transfer was the "sale" of the Store parcel by Ventures to Corp.

3/14/85 - transfer of Store parcel from KT to Ventures was a 100% change in ownership, Section 61(i);

3/85 - lease of Store parcel from Ventures to Corp for a term of 40 years was a change in ownership, Section 61(c);

8/23/94 - transfer of Store parcel from Ventures (as "owner," since lease to Corp had dropped under 35 years) to KT and to Corp in proportionate shares, reflecting their respective partnership interests, was a change in ownership under Section 61(i), but excluded under Section 62(a)(2);

8/23/94 - transfer of 50% of Store parcel from the former "KT" (now Group and Taylor as tenants-in-common) to Corp was a 50% change in ownership under Section 61(e), or was a 100% change in ownership, assuming it was part of the same transaction liquidating the assets of Ventures to its former partners in order to make the sale to Corp.

It is clear from the outset that if Ventures had first distributed or sold for an equivalent amount of cash, 100% of the real property directly to Corp, rather than transferring 50% to each partner (in proportion to their partnership interests), then the exclusion under Section 62(a)(2) would not have been applicable, because only exactly proportional transfers of interests in real property and/or interests in legal entities are excluded thereby. However, by dissolving the partnership, and distributing to KT and Corp their respective 50% interests in the real property, and then having KT transfer its 50% interest to Corp, the parties were undertaking an extra step to effect the transfer to Corp, in an attempt to utilize the Section 62(a)(2) exclusion.

This is exactly the type of situation the step transaction doctrine was intended to address in authorizing the assessor to "look through" the transaction. We have advised (Letters to Assessors Nos. 92/69 and 95/33) that step transaction decisions leading to reassessment should be made by assessor if, based upon all of the facts of any given transaction, those facts demonstrate that, in substance, a change in ownership has occurred. 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 expressly recognized that an independent business purpose for each of the several steps, while of some significance, does not prevent the assessor from finding that the step transaction doctrine applies and that a true change in ownership occurred.

Moreover, the McMillin court held that the assessor may be assisted in determining the true substance of a particular transaction by finding that only one of the three tests was satisfied. In applying the "interdependence test," the court found that the true substance of the transaction in that case was a purchase of 1,200 acres of land for \$100 million, resulting in a change in

ownership. A reasonable interpretation of the facts, said the court, indicated that 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. (There was no evidence that the developer, who joined in step four, had the same related purpose and intent as the two original affiliated corporations).

The parties in the instant case apparently did have the same related purpose and intent since the beginning. That is, all parties intended that Corp would function as the "owner" of the Store parcel. Thus, all three tests in Shuwa are satisfied when the step transaction doctrine is applied. Under both the "end result" test and the "binding commitment" test, KT, Corp and Ventures have been pursuing a related intent throughout the entire transaction. Corp initially leased the property for a 40-year term, constructed certain improvements on the property, mortgaged the property, and operated its business on the property. KT, on the other hand, was the managing partner and the shopping center developer (Partnership Agreement, paragraph 12), with the authority to increase its partnership interests to 75%, if and when it purchased certain additional properties and contributed them to Ventures. In the event of KT's failure to acquire and develop such properties for Ventures, Corp had the option to purchase the Store parcel so that its business operations there would continue.

Further, when the transfer of the property to Corp actually occurred, KT, Corp and Ventures had executed agreements (Dissolution Agreement and the Purchase and Sale Agreement) binding themselves to the two steps, which were to be completed on or about the same date, but in no event later than August 24, 1994. As set forth in the Finkelstein (Corp's attorney) Letter, 8/17/94 to Stewart Title Company, page 3, all of the escrow conditions were to be fulfilled on or before August 24, 1994, and all deeds from Ventures to the partners as tenants in common and from the tenants in common (who formerly comprised KT) to Corp were to be recorded in the order specified. The closing documents substantiate the foregoing:

8/23/94 Partnership Grant Deed from Ventures to KT and Corp (no documentary transfer tax "since seller and buyer are comprised of the same parties with the same proportionate interests.")

8/23/94 Final Closing Statements indicating transfer of properties for consideration from KT to Corp (except in one instance from KT to a "straw man" or holding company for Corp).

Under the "end result test" in Shuwa, the simultaneous distribution of Ventures' real property to KT and Corp, and the sale of KT's interest in the same property on one day, indicates that the parties intended both steps to be component parts of a single transaction. As to the "interdependence test," the relationship between the two steps, as documented by the agreements, documents and deeds, discloses that first step, the liquidation of Ventures, would not have been undertaken without the other step, the sale of KT's entire interest in the property to Corp, thereby indicating the parties' intent to attempt to utilize the Section 62(a)(2) exclusion. Under the "binding commitment test," as previously noted, the parties' agreements to undertake the

liquidation of Ventures and to close escrow on the sale of KT's interest in the property to Corp, in effect, constitutes a binding commitment to follow through with the entire transaction.

Notwithstanding the foregoing, the parties have asserted the same argument offered by the appellants in the Shuwa case, that the structure of these steps limits the property tax consequences to only a 50% reassessment. In Shuwa, the Atlantic Richfield Company (ARCO) and Bank of America (BofA) were equal partners in a partnership which owned an office complex in Los Angeles, known as ARCO Plaza. In 1986, ARCO and BofA, intending to sell ARCO Plaza to Shuwa Investments, structured the following three-step transaction: in step 1, ARCO would sell its 50% partnership interest to Shuwa; in step 2, Partnership would liquidate and distribute undivided interests in 50% of ARCO Plaza to BofA and Shuwa; and in step 3, BofA would sell its 50% interest in ARCO Plaza to Shuwa, giving Shuwa 100% ownership. On appeal, Shuwa conceded that step 3 resulted in a change in ownership under Section 61(e), but only to the extent of BofA's 50% transfer, thereby triggering a 50% reassessment. However, we note that the court rejected this argument, holding instead that under each of the relevant tests, all of the transactions in the case had to be "stepped together to reveal what actually occurred - the acquisition by Shuwa of 100 percent of the ARCO Plaza." (See Shuwa, at p.1650.)

Similarly, in Munkdale v. Ronald Giannini (1995) 35 Cal.App.4th 1104, the court applied all three tests to a hypothetical two-step transfer posited by the Munkdale brothers, who dissolved their partnership and distributed its real property to themselves in disproportionate shares. They suggested that had they taken the following two steps only a 50% change in ownership would result: 1) transfer the real property from their dissolved partnership to themselves as tenants in common in proportionate shares, and 2) transfer fractional tenancy in common interests in the property to each other for the purpose of vesting sole ownership of each parcel in only one person. Again, the court held that all of the tests applying the step transaction doctrine would have been satisfied in such a case, since the evidence clearly demonstrated that the Munkdales intended to sever their business relationship and to go their separate ways as individual owners of fee simple interests in each of the properties. Therefore, the property would still be subject to a 100% reassessment, despite the "stepping" of the transaction.

The evidence submitted in the instant case is quite similar to the court's hypothetical in Munkdale in that the Ventures' partners utilized a two-step procedure to structure the sale. No doubt they could have structured it differently so as to limit the property tax consequences to a 50% reassessment had KT not determined to sell and Corp determined to purchase KT's 50% interest. However, this was not their intent. Moreover, had the parties continued the Ventures partnership and authorized KT to merely transfer any amount of its partnership interests to Corp so that Corp owned more than 50% of Ventures, the result would also be a 100% reappraisal of the Store parcel. Under the provisions of Section 64(c), Corp would have obtained "control" of Ventures by obtaining a majority (more than 50%) of its interests in the partnership capital and profits. In effect, such a transfer of partnership interests from KT to Corp would simply be a more indirect method of KT "selling" its interests in the Store parcel to Corp. Utilizing two steps instead of one to accomplish this, triggers the application of the step transaction doctrine as previously discussed.

Effect of Corp's 40-Year Lease of Store parcel from Ventures.

The 1985 Partnership Agreement submitted for our consideration indicates that Corp entered into a 40-year lease of the Store parcel immediately after KT's transfer of that property to Ventures. Although we assume that such lease was executed and effective at the time of these transactions, (paragraph 10.1, Purchase and Sale Agreement) a copy has not been provided. As previously noted, this analysis is based on the assumption that the lease term was for 40 years (termination date 12/31/25) and did not contain any extensions or renewable options. Therefore, pursuant to Section 61(c)(1), the creation of the leasehold interest in the Store parcel for a term of 35 years or more was a change in ownership of the property at that time, i.e., in 3/85. Likewise, Section 61(c)(1) requires that when there is a transfer of a lessor's interest in property which was subject to a lease with a remaining term of less than 35 years (including any renewal options), a change in ownership occurs. Thus, if Corp's 40-year lease with Ventures was executed in 1985, and the lease continued, without modifications extending the term, until August 23, 1994, then the remaining term of the lease was less than 35 years at the time of Ventures' transfer of Store parcel to KT and Corp.

If, on the other hand, Corp and Ventures had extended the 40-year lease, so that the lease term upon the August 23, 1994 partnership liquidation and sale had not dropped below 35 years, then Corp would have continued to be the "owner" of the present interests in the Store parcel and no change in ownership would have occurred. Pursuant to Rule 462.100(b), the transfer of a leasehold interest in real property with a remaining term of 35 years or more does not constitute a change in ownership of the real property transferred.

The views expressed in this letter are, of course, 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,

Senior Tax Counsel

KEC:ba

cc: Mr.

Mr.

Mr.

Ms. J.

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