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January 28, 2015

Re: *Revenue and Taxation Code Section 62(d) and Income Interests for a Term of Years Assignment No. 14-061*

Dear Mr. _____ :

This is in response to your request for our opinion as to the property tax consequences of transfers of income interests to a trust for a term less than 35 years, as set forth in Revenue and Taxation Code¹ section 62, subdivision (d) (hereafter section 62(d)), Property Tax Rule² 462.160, subdivisions (b)(1)(B) and (d)(3), (hereafter Rule 462.160(b)(1)(B) and Rule 462.160(d)(3)), and Rule 462.060, subdivision (b) (hereafter Rule 462.060(b).) Specifically, you ask "[w]ould a transfer to a trust where the present beneficiary has an income interest for a term less than 35 years be a change in ownership?" You ask us to assume the transferor retains a reversionary interest in the real property.

As explained below, it is our opinion that a transfer of property to a trust where the present beneficiary has an income interest for a term less than 35 years is not a change in ownership of that property unless the trust to which the property is transferred qualifies as a "Clifford Trust" and the property does not revert to the grantor within 12 years as required by section 62(d). However, in our view, where the transfer of an income interest is to a trust that is not a Clifford Trust, the transfer would be analyzed according to the estate for years rule as set forth in Rule 462.060(b).

You also requested that the Board delete Property Tax Annotation³ (Annotation) 220.0766 (February 23, 1983). As discussed below, we will recommend deletion of the Annotation due to its ambiguity.

¹ All section references are to the Revenue and Taxation Code unless otherwise noted.

² All subsequent references to "Rules" are to the Property Tax Rules promulgated under title 18 of the California Code of Regulations.

³ Property Tax Annotations are summaries of the conclusions reached in selected legal rulings of Board legal counsel published in the Board's Property Tax Law Guide and on the Board's website. See Cal. Code Regs, tit. 18, § 5700 for more information regarding annotations.

Law & Analysis

Article XIII A, section 2 of the California Constitution requires the reassessment of real property upon a "change in ownership." 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."

Generally, the transfer of real property into a trust is a change in ownership of such property at the time of the transfer. (Rule 462.160, subd. (a).) However, section 62(d), states, in relevant part, that "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" is not a change in ownership. (Rev. & Tax. Code, §62, subd. (d).)⁴ This portion of section 62(d) did not appear in the Report of the Task Force on Property Tax Administration to the Assembly Committee on Revenue and Taxation (Task Force Report) in January 1979, but appeared for the first time in a summary of the provisions of Assembly Bill No. 156, the precursor to Assembly Bill No. 1488 (AB 1488) – part of the legislation implementing Proposition 13 – without discussion or explanation as to its rationale. (Assem. Com. on Revenue and Taxation, analysis of Assem. Bill No. 156 (1979-1980 Reg. Sess.) as amended April 25, 1979, p. 4.) However, in its initial opposition to the last clause of section 62(d) in June 1979, the provision is identified by the Department of Finance as excluding from change in ownership property transferred to a Clifford Trust.⁵ AB 1488 was signed by the Governor and became law on July 10, 1979.⁶ By October 1979, the Assembly Revenue and Taxation Committee Staff Report, Implementation of Proposition 13, Volume I, Property Tax Assessment, clearly indicates that the Legislature intended that the last clause of section 62(d) applied only to Clifford Trusts.⁷

Helvering v. Clifford (1940) 309 U.S. 331 reviewed the income tax treatment of an irrevocable trust created for the benefit of a spouse. The trust terminated after 5 years at which time the trust property reverted to the grantor. The Court held that the trust income was taxable to the grantor. However, this case led to the codification of statutes addressing short-term trusts in the 1954 Internal Revenue Code that allowed grantors to create short-term trusts to transfer income to the trust beneficiary while retaining a reversionary interest in the trust property. These statutes were amended in the Tax Reform Act of 1986 to require a grantor to include as his income all income from any property in which the reversionary interest is more than 5 percent of the value of the portion of the trust to which the reversion relates. (26 U.S.C. §673.) Short-term trusts created under the pre-1986 statutes meeting the requirements of Internal Revenue Code (IRC) sections 671 to 679 are known as Clifford Trusts. (See 26 U.S.C. 671, et seq., hereafter IRC sections 671 to 679.) Clifford Trusts, thus, in short, are irrevocable, but temporary, trusts created primarily for income tax planning purposes, whereby income from the trust property is paid to the beneficiary and taxed to the beneficiary, but the property itself reverts back to the settlor when the trust expires.

⁴ This is the last clause of section 62(d).

⁵ See Cal. Dept. of Finance, analysis of Assem. Bill 1488 (1979-1980 Reg. Sess.) June 14, 1979, p. 1. See also Cal. Dept. of Finance, Enrolled Bill Report of Assem. Bill 1488 (1979-1980 Reg. Sess.) June 28, 1979, pp. 1-2.

⁶ Stat. 1979, ch. 242, §4.

⁷ Assembly Revenue and Taxation Committee Staff Report on Implementation of Proposition 13, Volume 1, Property Tax Assessment, October 29, 1979, p. 24.

To be considered a valid Clifford Trust, the trust terms must have complied with IRC sections 671 to 679, as codified in 1954. These statutes set forth three main standards that had to be met before the trust would be considered to validly transfer income to the beneficiary. First, the trust corpus must not revert to the grantor within ten years of the trust's creation. Second, the trust corpus must not be subject to the grantor's power of disposition. Third, the corpus must not be subject to any exercise of discretion for the individual benefit of the grantor. (Choi, *Clifford Trusts: Proposals for Resolution of the Gift-Leaseback Conflict* (1985) 58 So. Cal. L. Rev. 1409, 1413-1414.) More specifically, the separate existence of the Clifford Trust was to be ignored if the grantor or another person with a nonadverse interest in the trust property had retained substantial dominion or control over the trust property. (Soled, *Reforming the Grantor Trust Rules* (2001) 76 Notre Dame L. Rev. 375, 389-392.) IRC sections 671 to 679 set forth factors that described a grantor's substantial dominion or control over property. These included situations where the beneficial enjoyment of the trust corpus was subject to a power of disposition by the grantor without the consent of an adverse party, the power to deal for less than adequate and full consideration, the power to borrow without adequate interest/security, the power to borrow trust funds, general powers of administration (such as the power to vote or direct the voting of stock/securities, control investments by directing or vetoing, or substitute property), the power to revoke, and the power to distribute or hold for future distribution income to the grantor or grantor's spouse (or to apply such income to the payment of premiums on insurance policies of grantor or grantor's spouse). (26 U.S.C. §§ 673-678.)

Based on the rights transferred when property is transferred to a Clifford Trust, it appears that in enacting section 62(d), the Legislature made a determination that the creation of a Clifford Trust constituted a change in ownership of the real property transferred to the trust, thereby necessitating the statutory exclusion for such transfers. This is because a transfer to a Clifford Trust would have met the three-part change in ownership test of section 60, since, pursuant to the IRC requirements, the rights to the real property the grantor transfers when creating a Clifford Trust included the present, beneficial ownership in the property substantially equivalent to the fee interest.

Rule 462.060(b) provides that the creation or transfer of an estate for years for less than 35 years is not a change in ownership, while an estate for years for a term of 35 years or more in real property is a change in ownership at the time of transfer (unless the instrument creating the estate for years reserves such estate in the transferor or the transferor's spouse, or registered domestic partner). (Rule 462.060, subd. (b).) This rule was adopted May 5, 1981, effective August 12, 1981. (Letters to Assessors 81/91 (August 7, 1981); 1981 Minutes of the State Board of Equalization for Tuesday, May 5.) There was no explanation for adding this subdivision other than that the Rule in general "provides necessary guidance for the reappraisal of property which changes ownership"⁸ and that the amendment was "more in the nature of technical reorganization than substantive." (Order Amending Regulation 462 of the State Board of Equalization, Final Statement of Reasons (June 1981).)

⁸ Face Sheet for Filing Administrative Regulations with the Office of Administrative Law and with the Secretary of State, regarding the Board of Equalization's amendment of Title 18, California Administrative Code section 462 (May 5, 1981).

Notably, deeming an estate for years that is 35 years or longer to be a change in ownership mirrors section 61, subdivision (c), which provides that the creation of a leasehold interest in taxable real property for a term of 35 years or more is a change in ownership. The 1979 Task Force Report adopted 35 years as the concrete dividing line in order to meet the value equivalence test for change in ownership purposes, and specifically made it 35 years because lenders will lend on the security of a lease for 35 years or longer.⁹ The Task Force Report stated that it was important to draw that distinction in order "to identify but one primary owner" at any given time, based on who owned the main economic value. (*Id.* at p. 39-40.) Thus, even though a lease for 40 years, for example, is not a fee simple ownership because it is not perpetual, the Legislature statutorily deemed any lease for 35 years or longer to be "substantially equal to the value of the fee interest" for property tax change in ownership purposes. We believe the same principles underlie the 35-year rules on estates for years.

In light of the legislative and regulatory history outlined above, we believe that the last clause of section 62(d) pertains only to transfers to a Clifford Trust (i.e., those trusts that meet the requirements of IRC section 671-679 as enacted prior to 1986). However, where an income interest is transferred to a trust that is not a Clifford Trust, such interest should be analyzed pursuant to the rules set forth in Rule 462.060.

Finally, you assert that Annotation 220.0766 misunderstands the last clause of section 62(d). That annotation states that the assessor reassessed real property transferred to an irrevocable trust for a term of 12 years and 5 months because the term was in excess of 12 years, pursuant to sections 62(d). (Annotation 220.0766, *supra.*) However, the backup letter does not indicate whether the assessor's decision was correct. Instead, the focus of that portion of the backup letter is on whether a "retroactive amendment" of a trust document would be valid. There is no discussion of the terms of the trust, including whether or not the trust qualified as a Clifford Trust. As such, we believe the annotation may be a potential source of confusion. For that reason, we will recommend its deletion.

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

Sincerely,

/s/ Susan Galbraith

Susan Galbraith
Tax Counsel

SG:yg

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cc: President, California Assessors' Association
Mr. Dean Kinnee MIC:64
Mr. Benjamin Tang MIC:64
Mr. Todd Gilman MIC:70

⁹ The Report of the Task Force on Property Tax Administration to the Assembly Committee on Revenue and Taxation, January 22, 1979, p. 41.