STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94278-0001

(916) 445-4588

February 28, 1990

Honorable Alfred E. Carlson
Santa Clara County Assessor
County Government Center East Wing
70 West Hedding Street
San Jose, CA 95110
Attn: Ms. Barbara Herlihy
Property Transfer Unit

Dear Ms. Herlihy:

This is in response to your FAX letter of November 25, 1991, requesting the views of this office on the question of whether the acquisition of a 15% interest in a limited partnership, by a partner who already holds a 45% interest, results in a change in ownership of the partnership property.

Briefly, a limited partnership was formed in 1982 with eleven partners. R.Mc had a total 45% interest in capital and profits (16% - general partner; 29% - limited partner). Four educational trusts each held a 10% limited partner interest (total of 40%). The beneficiaries of these trusts were the four children of R.Mc, who was the trustee of each trust. In addition, J.B. held a 5% general partner interest, while R.B., D.B., M.L., I.M., and J.D., each held a 2% limited partner interest. Your letter states that the indicated percentages refer to the percentage interest in the partnership capital and profits. Recently, R.Mc acquired the partnership interests of J.B., R.B., D.B., M.L., I.N., and J.D. (a total of 15%). Based upon this acquisition your office concluded that R.MC. obtained a majority ownership interest in the partnership as the result of this acquisition and, in accordance with Revenue and Taxation Code Section 64(c), have reappraised the property of the partnership. R.Mc contends that the acquisition of the 15% did not result in a change in ownership because he already owned, directly or indirectly, 85% of the partnership. The critical question seems to be, therefore, whether R.Mc should be considered to be the owner of the 40% partnership interest held by his children's four educational trusts because he is the trustee of these irrevocable trusts. We conclude that he should not be considered to be the owner of the 40% interest for change in ownership purposes.

Revenue and Taxation Code section 64 contains the change in ownership provisions applicable to transfers of ownership interests in legal entities, such as corporate stock or partnership interests. Subdivision (c) of that section provides that when a corporation, partnership or other person obtains "control, as defined in Section 25105, in any corporation, or obtains a majority ownership interest in any partnership" through the purchase or transfer of corporate stock or partnership interests, there shall be a change in ownership of the property owned by the corporation or partnership.

Section 64 is implemented and interpreted by subdivision (j) of Property Tax Rule 462 (18 Cal. Code of Regs. §462). Subdivision (j) (4) (A) provides, in part, that when any corporation, partnership or other person obtains, "direct or indirect ownership" of more than 50% of the total interest in both partnership capital and profits, there is a change in ownership of the partnership property. Specifically, the subdivision provides, in part, "upon the acquisition of such direct or indirect ownership or control, all of the property owned directly or indirectly by the acquired legal entity is deemed to have undergone a change in ownership".

Nothing in either the statute or the regulation deals specifically with the question of whether the trustee of a trust which owns an interest in a partnership should be considered to be an owner of the partnership interest for purposes of the provisions described above. Further, we are not aware of any appellate court decision dealing with this issue. Thus, our conclusions must be based upon our interpretation of the language of the statute and regulations.

Subdivision (c) of Revenue and Taxation Code section 64 makes a clear distinction between the change of ownership standard applied to corporations (i.e., control as defined in section 25105) and the standard applied to partnerships (i.e., majority ownership. This distinction is reflected in Rule 462 which contains separate provisions for corporations and partnerships. The portion of the regulation dealing with the partnerships, subdivision (j) (4) (A) (ii), refers to "direct or indirect ownership of more than 50% of the total interest of both partnership capital and profits". This standard is distinct from the standard applicable to corporations which refers to ownership or control. Even though the language of the closing paragraph in subdivision (j) (4) (A) refers to "direct or indirect ownership or control" the preceding language makes clear that the reference to "control" is included because it refers to the standard applied to corporations. We have never interpreted this language as extending the "control" standard to partnerships. Thus, the question is not whether R.Mc had control of more than 50% of the partnership interest. It is whether R.Mc had direct or indirect ownership of more than 50% of the partnership interest.

The facts presented indicate that the subject 40% interest in the partnership was owned by the four educational trusts (10% each). The discussion presented on behalf of R.Mc seems to concede that he does not have direct ownership of the 40% partnership interest. There is a suggestion, however, that as trustee, he has indirect ownership. The suggestion that R.Mc indirectly owns the 40% interest is apparently based on the argument that he has control of the asset and, therefore, has indirect ownership of it. As indicated in the statute and regulation, there is a clear distinction made between ownership and control. For partnership purposes, control is not tantamount to ownership.

Indirect ownership occurs, for example, where A owns all of the stock of corporation X which owns a 40% interest in partnership P. In that situation A would be the indirect owner of the 40% interest in P. In our opinion, R.Mc does not have indirect ownership, as that term is used in Rule 462, of the 40% partnership interest held by the four educational trusts simply because R.Mc is the trustee of each of those trusts. Thus, under the facts presented, we conclude that R.Mc held only a 45% interest, rather than an 85% interest, in the subject partnership in 1982. When R.Mc acquired the additional 15% partnership interest, he acquired a majority ownership interest which triggered a change in ownership under the terms of Revenue and Taxation Code section 64 (c) and rule 462 (j).

A number of arguments are advanced on behalf of the taxpayer's position based upon an April 11, 1983 letter written by Eric Eisenlauer, Board staff attorney, and upon two court cases interpreting Revenue and Taxation Code section 25105 for franchise tax purposes. For various reasons, we do not fine these authorities to be persuasive.

Mr. Eisenlauer's letter deals with the question of whether an individual had obtained control of the voting stock of a corporation. He the partnership at issue here been a corporation, we might have agreed with the taxpayer's position, based upon Mr. Eisenlauer's letter. As explained above, however, the standard applicable to partnerships is ownership and not control. Thus, Mr. Eisenlauer's letter is not applicable to the situation before us.

In Rainbird Sprinkler Mfg. Corp. v. Franchise Tax Board (4/25/91) 229 Cal. App. 3d 784, the court dealt with the question of whether some 17 corporations engaged in various aspects of the manufacture and sale of Rainbird sprinklers should be treated as a unitary business for franchise tax purpose where a majority stock interest in each corporation was held by a mother and her two children. The Rainbird decision discusses a related case dealing with a similar issue, See Hugo Neu-Proler Internat. Sales Corp. v. Franchise Tax Board (1987) 195 Cal. App. 3d 326. Since those decisions deal with Revenue and Taxation Code section 25105, the standard applicable to corporations, we fail to see how they apply to the partnership problem presented here. Further, we have previously considered these decisions and have concluded that these decisions have no legal effect upon property tax change in ownership questions. Attached for your information is a copy of my July 10 memo on this subject.

The views expressed above are, of course, advisory in nature. 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,

Richard H. Ochsner
Assistant Chief Counsel

RHO:ta
3781D
Attachment
cc: Mr. John W. Hagerty
Mr. Verne Walton
Mr. Eric F. Eisenlauer

MEMORANDUM

To: Mr. Verne Walton, Chief
Assessment Standards Division

Date: July 10, 1991

From: Mr. Richard H. Ochsner
Assistant Chief Counsel

Subject: Rainbird Sprinkler Mfg. Corp. v. Franchise Tax Board
(04/25/91) 229 Cal. App. 3d 784

This will acknowledge receipt of your May 9, 1991 memo transmitting a copy of the above appellate court decision, together with a copy of a letter from Mr. Max Goodrich, Director of the Ownership, Exemptions and Mapping Division of the Los Angeles Assessor's Office. Mr. Goodrich's letter brings the case to your attention and suggests that it "ought to be closely reviewed by Board staff to determine its application to our change of ownership rules". Mr. Goodrich does not indicate whether he concludes the case does have any application, or if so, what tat application is. Your memo is equally opaque.

While it is not clear whether your memo was intended as a request for an opinion, I have treated it as such. I assume that you would like to know whether I feel the Rainbird case has any impact upon the change in ownership rules because it interprets Revenue and Taxation Code section 25105 in order to determine whether a group of corporations should be treated as a unitary business for franchise tax purposes. For the reasons set forth below, I have concluded that the decision has no impact upon the change in ownership rules.

The Rainbird case involves the question of whether or not seventeen corporations engage in various aspects of the manufacture and sale of Rainbird sprinklers should be treated as a unitary business for franchise tax purposes where a majority stock interest in each corporation was held by a mother and her two children. The sprinkler business was founded in 1946 by husband and wife to manufacture impact drive sprinklers for agricultural and horticultural irrigation systems. As the business grew, other corporations were formed to conduct the manufacture and sales of sprinklers and related equipment. When the husband died in 1963, his stock interest in the Rainbird group of corporations passes to his wife and two children. With the exception of certain minor stockholdings by key employees, all of the stock of the corporations was held by the mother and her two children. All stock of each corporation was subject to purchase agreements that prohibit the transfer of stock by a shareholder to anyone other than the corporation or its shareholders. The mother and her son and son-in-law held virtually all corporate offices in each of the corporations. With one exception, they also comprised the board of directors of all corporations. The Franchise Tax Board determined that Rainbird was entitled to file its franchise tax return on a unitary basis with only three of its affiliates for 1974 and only four of its affiliates for 1975. This was based upon the fact that the mother owned more than 50% of the stock of those corporations in those years. The Board of Equalization sustained the position of the Franchise Tax Board, but the trial court found that all seventeen corporations were entitled to file on a unitary basis.

The District Court of Appeal affirmed, finding that the three-prong unitary business test: Unity of ownership, unity of operation, and unity of use, were present in this case. While the parties agreed that unity of operation and unity of use were present, the Franchise Tax Board argued that unity of ownership exists only when a single individual or entity owns more than 50 percent of the voting stock of each corporation included in the unitary group. The unity of ownership test set forth in Revenue and Taxation Code section 25105 provides: "Direct or indirect ownership or control of more than 50 percent of the voting stock of the taxpayer shall constitute ownership or control for the purposes of this article". In applying this language for unitary tax purposes, the question presented is whether the ownership of only a single individual or entity may be considered when applying the 50 percent test or whether there can be attribution of ownership between related stockholders in satisfying the unity of ownership test.

In concluding that attribution of ownership between related stockholders is appropriate for purposes of satisfying the unity of ownership test, the court relies upon Hugo Neu-Proler Internat. Sales Corp. v. Franchise Tax Board (1987) 195 Cal. App. 3d 326, the only published case interpreting the statute. It held that ownership and control could be attributed to two corporate partners, each indirectly owning 50 percent of the stock of a third corporation. In the Hugo case, the Court of Appeal approved the trial court's finding that attribution of ownership between closely related parties, such as business partners, is a well-established principle of tax law, and the statutory language of section 25105 referring to "direct or indirect ownership or control" clearly implies a legislative intent that the principle of attribution should apply to partners to satisfy the unity of ownership test in a multiple entity business. In approving the holding in Hugo, the court goes on to observe that attribution of stock among family members is an established principle of tax law, citing 26 U.S.C.A. section 318.

An important element of the analysis in Rainbird is the conclusion that nothing in the language of section 25105 requires that ownership be held by a single individual or entity to meet the unity of ownership test. Section 25105 merely refers to "direct or indirect ownership or control" without specifying whether one or more owners are referenced. The court uses this ambiguity as a basis for interpreting the Legislature's meaning and concludes that nothing in the statute precludes the ownership test from being met where ownership is held by the members of a closely related group.

It should be recognized that the decision in Rainbird is directed solely to the question of whether a group of related corporations should be treated as a unitary business for franchise tax purposes. Nothing in the Rainbird opinion indicates that the court considered any other tax issue, particularly the application of section 25105 in a property tax context. The same comment applies to the Hugo case. While these cases contain some general language regarding attribution, those comments were made solely in the context of the traditional test used to determine whether a unitary business exists for purposes of income taxation. It would be inappropriate, therefore, to attempt to read the holdings in these cases as being directly applicable to change in ownership questions.

It is also apparent that there is a critical distinction between the language found in section 25105 and the language applicable to changes in ownership. Subdivision (a) of Revenue and Taxation Code section 64 states the general rule that the transfer of ownership interests in legal entities in not a change in ownership of the real property of the entity, with certain exceptions.

Subdivision (c) expresses the primary exception to that general rule. Insofar as corporations are concerned, it applies a test utilizing section 25105. Subdivision (c) states: "When a corporation, partnership or other legal entity or any other person obtains control, as defined in section 25105, in any corporation" there is a change in ownership of the property of the corporation in which the controlling interest is obtained. The quoted language seems clear and unambiguous. It refers to a single corporation, partnership, and so forth, which obtains control as defined in section 25105.

The general rule of statutory construction is that clear and unambiguous language is controlling. Words should be given their ordinary meaning and courts may not add language to a provision that is plain and definite. See Delaney v. Superior Court (1990) 50 Cal. 3d 785. The ordinary meaning of the language found in subdivision (c) of section 64 is that the control defined in section 25105 must be obtained by a single corporation, partnership, etc. This seems clear and unambiguous. The contemporaneous construction of the language found in Property Tax Rule 462, subdivision (j) (4) (A) is consistent with the statute. It recognizes that a change in ownership occurs: "When any corporation, partnership, other legal entity or any person" obtains direct or indirect control of more than 50 percent of the voting stock in any corporation, partnership, legal entity or person, is singular. It has been my experience that the staff's application of the statute and regulation has consistently reflected the fact that the language is in the singular. We have gone so far as to recognize the separate ownership of corporate stock by husband and wife.

Unlike the situation dealt with in Rainbird, where nothing in the language of section 25105 requires that ownership be held by a single individual or entity, the language of Section 64 (c) clearly requires such singular ownership. This important statutory distinction makes the reasoning in Rainbird inapplicable. Contrary to the situation in Rainbird where the absence of express language in the statute allowed the court to imply a legislative intent to embrace the principle of attribution, section 64 (c) expressly requires ownership by a single legal entity or individual. In light of the plain meaning of the section, there is no basis for applying the type of statutory construction found in Rainbird.

While it might be quite logical to apply attribution principles when discussing the three-prong unity test used to determine where a business is unitary, that logic does not necessarily carry over to the change in ownership area. When determining whether unity of ownership exists, for unitary purposes, it must also be determined whether unity of operation and unity of use also exist. Unity of operation and unity of use are essentially factual questions. In discussing the unity of ownership requirement, the court in Rainbird states that the requirement is based upon the need for the existence of effective common control over a functionally integrated business entity. The court says that it is the reality of control, not its form or mode that should be determinative. All of this may be quite logical for purposes of determining whether a collection of entities should be treated as a unitary business for tax accounting purposes. The same sorts of considerations are not necessarily applicable to the change in ownership question.

Change in ownership is an arbitrary concept created by statute. With only a couple of exceptions, the Legislature has given full recognition to the theory that a corporation or partnership is a separate legal

person. Section 64 (c) is the primary exception to that approach. In adopting subdivision (c), the Legislature established an arbitrary bright line test for determining when the acquisition of ownership interests in a legal entity will be treated as a change in ownership. In the case of corporations, they adopted the test set forth in section 25105, more than 50 percent of the voting stock.

If the reasoning of the Rainbird and Hugo cases is applied to section 64 I, you to get a very illogical result. The Hugo case dealt with a partnership made up of two corporations which owned all of the stock of a third corporation. Using attribution rules, the court found unity of ownership even though neither of the corporate partnerships had more than a 50 percent interest in either the partnership or, indirectly, in the third corporation. In order to reach this result, the court attributed the ownership interest of one partner to ownership interest of the other. The key to this analysis is the attribution of the indirect ownership interest in the third corporation of one partner to the other partner in order to achieve a more than 50 percent ownership. If this reasoning is applied in the context of a change in ownership question, the result would be virtual elimination of the basic section 64 rule that the acquisition of an ownership interest in a corporation or a partnership is generally not a change in ownership.

If we have two partners, A and B, each owning a 50 percent interest in a partnership which owns 100 percent of the stock of corporation X, the transfer of A's 50 percent partnership interest to C would result in a 100 percent change in ownership of corporation X, applying the Hugo and Rainbird attribution principles. That is, since C would become B's partner, B's ownership interest would be attributed to C, as was done in Hugo. The same would be true if A's partnership interest was only 10 percent or only 1 percent. Thus, the application of the attribution rules would, for the most part, repeal the provisions of subdivision (a) of section 64. It would be illogical to assume that the Legislator intended such a result.

As you probably know, legislation sponsored by the Los Angeles County Assessor's Office has been introduced in past years which proposed change in ownership attribution rules. That legislation has not been adopted, however. The failure of the Legislature to adopt such attribution rules supports our conclusion that the current statutory language does not now permit the application of attribution principles to section 64 I.

For the reasons stated above, I conclude that the Rainbird decision has no legal effect upon property tax change in ownership questions. I note that the letter from the Los Angeles County Assessor's Office expresses no opinion on this subject. The letter merely suggests that the case ought to be closely reviewed. If either you or the Los Angeles County Assessor's Office disagree with our analysis, we would be happy to consider your views.

RHO:ta
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cc: Mr. John W. Hagerty
Mr. E. L. Sorensen, Jr.
Mr. Charles Knudsen
Mr. Eric F. Eisenlauer
Mr. Carl Bessent