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August 1, 2012

**Re: *Change of Ownership Upon Sale to Defective Grantor Trust
Assignment No.: 12-053***

Dear Mr. _____ :

This is in response to your letter to Ms. _____, Acting Assistant Chief Counsel, regarding a proposed transaction which could be structured in several ways. Your client (Grantor) wishes to transfer certain rental property to an intentionally defective grantor trust (IDGT) in exchange for an installment note under three alternate repayment scenarios.

You asked whether a change in ownership will occur at the time the property is "sold" to the IDGT, at the time that the note is paid in full, or at some other time. As explained below, regardless of how repayment of the note is structured, a change in ownership will occur when Grantor transfers his property to the IDGT unless an exclusion is available.

Facts

We spoke by telephone on June 26, 2012 to clarify certain information not contained in your incoming letter, which information is included herein. For federal income tax purposes, in exchange for an installment note,¹ Grantor will transfer real property which is not used as his principal residence into an irrevocable IDGT. Once such property is transferred to the IDGT, Grantor would no longer have the power to sell or substitute the property. Grantor will not be a present or future beneficiary of the IDGT. Until the note to Grantor is repaid in full, although income may accumulate, no income may be paid out of the IDGT to any beneficiary.

Once the IDGT has repaid the note, the IDGT trustee has discretion to distribute (or not distribute) income and/or principal to the beneficiary (or beneficiaries). You state that the beneficiaries of the IDGT would likely be Grantor's wife for her lifetime with the remainder to Grantor's children, or in the alternative, Grantor's nieces and nephews.

Law & Analysis

¹ Repayment of the note is contemplated in three different scenarios, however all scenarios result in the same analysis.

Section 60 of the Revenue and Taxation Code² provides that a change in ownership occurs upon a transfer of a present interest in real property, including the beneficial use of the real property, with a value substantially equal to the value of the fee interest. Generally, a transfer of real property to a trust is a change in ownership of the property at the time of the transfer. (Property Tax Rule 462.160, subd. (a).³) An exception to this general rule is that a transfer of real property to a trust that is revocable by the trustor is not a change in ownership. (Rev. & Tax. Code, § 62, subd. (d); Rule 462.160, subd. (b)(2).) However, there is a change in ownership when that revocable trust becomes irrevocable unless the trustor remains the sole present beneficiary or unless there is another exclusion from change in ownership between the trustor and the beneficiary. (Rev. & Tax. Code, § 61, subd. (h); Rule 462.160, subd. (b)(2).)

An irrevocable trust is an arrangement in which the trustor relinquishes control of the property.⁴ The trustor cannot revoke or amend the trust after it is established. Thus, an irrevocable trust permanently dedicates the property transferred into the trust to the benefit of the trust beneficiaries.⁵ And because trusts are not treated as separate legal entities for property tax purposes (i.e., we "look through" the trust), the present beneficiary of an irrevocable trust is regarded as the owner of the property held in trust.⁶ The present beneficial owners of property held in an irrevocable trust are the named present beneficiaries, who may or may not include the trustor.⁷

Section 2, subdivision (h) of article XIII A of the California Constitution excludes from change in ownership "the purchase or transfer of the first one million dollars of the full cash value of all other real property between parents and their children, as defined by the Legislature." The California Legislature enacted section 63.1 to implement the exclusion for transfers between parents and children, and subdivision (c)(7) of that section extends the parent-child exclusion to transfers accomplished through the medium of a trust.

Where the trustee of an irrevocable trust has total discretion to distribute trust property or income to a number of potential beneficiaries ("sprinkle power"), the property is subject to change in ownership if any of the potential beneficiaries lack an exclusion. This is because even though the trustee may not elect to distribute the trust property or income to a non-excludable beneficiary, the trustee has the authority to make such a distribution.⁸ However, if all potential beneficiaries to whom the property may be distributed under the trustee's sprinkle power qualify for an exclusion, there is no change in ownership.

Here, Grantor proposes to transfer property to an irrevocable trust of which he is not a beneficiary. In accordance with subdivision (a) of Rule 462.160, this transfer to the IDGT will result in a change in ownership unless an exclusion applies. For purposes of determining whether any exclusion(s) is available, the present beneficiaries of the IDGT will be regarded as

² All further "section" references are to the Rev. & Tax. Code unless otherwise specified.

³ Cal. Code Regs., tit. 18, § 462.160, subd. (a). All further "Rule" references are to sections of title 18 of the California Code of Regulations.

⁴ See Assessors' Handbook Section 401, *Change in Ownership*, p. 24.

⁵ *Id.* at 24.

⁶ See Property Tax Annotation 220.0790.

⁷ See Assessors' Handbook Section 401, *Change in Ownership*, p. 24.

⁸ Rule 462.160, subd. (b)(1)(A).

the owner(s) of the property.⁹ As stated in Property Tax Annotation¹⁰ 625.0204, "It has long been our position since before the adoption of Proposition 58 that one may be the present beneficiary of a trust even though current income may be paid to such beneficiary or accumulated in the trustee's discretion as long as no other person presently has a right to income or principal." As such, even if the present beneficiaries of the IDGT cannot receive distributions from the IDGT until the note has been repaid, they are nevertheless the present beneficiaries since no other person has the right to income or principal from the IDGT.

If Grantor's wife is the sole present beneficiary of the IDGT, then the interspousal exclusion would apply and no change in ownership would occur when the property is transferred to the IDGT.¹¹ If Grantor has not used his \$1 million exclusion and Grantor's children become the present beneficiaries (upon the death of Grantor's wife or upon formation of the IDGT), by filing the appropriate claim forms the Grantor's children could avail themselves of the parent-child exclusion contained in section 63.1, subdivision (b)(2).¹² This would shield the first \$1 million of the property's full cash value from a change in ownership. By contrast, if Grantor's nieces and nephews are the IDGT beneficiaries, no exclusion is available and a change in ownership would occur when Grantor transfers the property into the IDGT or when the nieces and nephews become the present beneficiaries of the trust or receive the remainder interest in the property upon wife's death.

Your letter cites to two Property Tax Annotations, including Annotation 625.0204, which opined that the children of the grantors were the present beneficial owners of certain property held in trust where the trustee had no discretion to distribute income and must accumulate such income to be added to the principal of each child's respective trust during the life of the surviving grantor. You state that unlike Annotation 625.0204, the Grantor here is "effectively receiving most or all of the income." However, the payments received by Grantor from the IDGT would be received as a creditor pursuant to the terms of the note, not as owner of the property or as a beneficiary of the trust.¹³ For example, if the property were destroyed by fire and the insurance proceeds were paid in lump sum to the IDGT, Grantor would not receive the lump sum. Rather, he would continue receiving annual payments pursuant to the note. If the insurance proceeds exceeded the repayment terms of the note, the beneficiaries would receive that benefit after the note is repaid. Similarly, if the property generates more rental income than originally anticipated by Grantor, the beneficiaries would receive that benefit as well, albeit after the note is repaid.

Your letter also cites to Annotation 220.0810, which opined that the transfer of property to a charitable remainder annuity trust, charitable remainder unitrust, or charitable remainder net income trust, with the income therefrom reserved to the trustor as the present beneficiary and a charitable remainder in the property at the termination of the income interest, is not a change in ownership. Under those facts, although accumulated but undistributed trust income is added to the trust principal and distributed to the charitable remainderman, the trustor or the trustor's

⁹ See Property Tax Annotation 220.0790.

¹⁰ 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.

¹¹ § 63, subd. (a).

¹² We note that since this property is not a "principal residence," the parent-child exclusion contained in § 63.1, subd. (a)(1)(A) is not available.

¹³ Because Grantor does not retain an ownership interest in the property, this transaction differs from an installment sale contract. See AH 401, p.6 and Annotation 220.0321.

spouse is the present beneficiary of the trust. The letter states, "If, however, income is distributed by the trust to a present beneficiary other than the trustor or the trustor's spouse, the requirements of section 62(d) would not be met and the transfers of property to the trust would constitute a change in ownership." This is essentially the conclusion we reach in this letter.

The views expressed in this letter are 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. Should you have any additional questions, please feel free to contact me.

Sincerely,

/s/ Mary Anne B. Tooke

Mary Anne B. Tooke
Tax Counsel

MAT:mcb

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California Assessors' Association