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August 10, 2015

Re: *Parent-Child Exclusion – Non-Pro rata Trust Distributions*
Assignment No.: 15-146

Dear Mr. _____ :

This is in response to your request for our opinion on whether the parent-child exclusion applies to a proposed non-pro rata distribution of real property from a trust to the son and daughter of the trustor (Child A and Child B) when the distribution involves a loan from Child B to the trust and the loan is obtained by Child A in his capacity as the trustee. For the reasons set forth below, in our opinion, the parent-child exclusion applies under the circumstances you described, assuming all other conditions are met.

Facts

According to you, a trust (Trust) has one parcel of real property (Subject Property) that is to be distributed equally to the trustor's children, Child A and Child B. (See Article VII of the Trust.) Child A is the trustee of the Trust. The trustee has the power under the terms of the Trust instrument to make non-pro rata distributions of the Trust's property. (See Article V, Subdivision L of the Trust.)

You stated that the initial Trust administration tasks are complete and the Trust is now in a position to make distributions to the beneficiaries. In order to equalize the dollar value of distributed interests in the Subject Property to Child A and Child B, it is proposed that Child A, as the trustee, obtain a loan from Child B. In exchange for the loan, Child B will receive a promissory note that is secured by a deed of trust and payable by the trustee. The trustee will then distribute the Subject Property, which is encumbered by the loan, to Child A and make a cash distribution to Child B in an amount equal to the value of the equity in the Subject Property distributed to Child A. You asked whether such a proposed distribution of the Subject Property would qualify for the parent-child exclusion.

Law and Analysis

The parent-child exclusion (Proposition 58) was added to section 2, subdivision (h), of Article XIII A of the California Constitution on November 6, 1986, and is implemented by Revenue and Taxation Code section¹ 63.1. Specifically, it excludes from change in ownership certain transfers of real property between parents and their children. Subdivision (c)(9) of

¹ All statutory references are to the Revenue and Taxation Code unless otherwise indicated.

section 63.1 defines "transfer" to include "any transfer of the present beneficial ownership of property from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust." Therefore, if the transfer of real property from the trust to the children of the trustor qualifies as a transfer from the trustor (i.e., the eligible transferor) to the transferee(s) pursuant to the terms of the trust, then the transfer is a transfer between parent(s) and child(ren), and, assuming all other conditions are met, qualifies for the parent-child exclusion.

In determining whether a transfer from the trust is a transfer from the *trustor* to the transferee, the critical factor is whether the trust instrument limits the trustee's powers to distribute property. (See, e.g., the March 14, 2000 backup letter to Property Tax Annotation (Annotation)² 625.0235.) A trustee enjoys not only the powers conferred by the trust instrument but also, except as limited in the trust instrument, the powers conferred by statute. (Prob. Code, § 16200.) As relevant here, one such express statutory power on trustees is "the power to effect distribution of property and money in divided or undivided interests and to adjust resulting differences in valuation. A distribution in kind may be made pro rata or non-pro rata." (Prob. Code, §16246.)³

The Annotations provide guidance on the applicability of the parent-child exclusion to certain transfers from trusts. Specifically, Annotation 625.0235 provides:

When a parent transfers property to a trust which provides that the children are to receive the trust assets on a share and share alike basis, unless the trust instrument specifies otherwise, the trustee has the power to distribute the property on a pro rata or non-pro rata basis. The distribution of sole ownership of a single asset to one child would qualify for the parent-child exclusion, except to the extent the value of the asset exceeds the value of that child's interest in the total trust estate. Such excess must be considered a non-excludable transfer from the other beneficiaries pursuant to a sale of their interests to the recipient.

(See also LTA No. 91/08, p.2.) Similarly, Annotation 625.0201 provides that the parent-child exclusion applies when "a trustee's statutory powers are not limited by the trust instrument, the trust instrument requires distribution to children in equal shares, and the trustee encumbers the trust real property after the trustor's death for purposes of distributing the real property to one child subject to the encumbrance and cash in an amount equal to the equity in the real property to the other child." (Annotation 625.0201.) However, only the trustee can encumber the real property with a loan, and the beneficiary receiving the real property may not make the loan to the trust to equalize the distribution. (September 5, 2007 Backup letter to Annotation 625.0235.005, p.5.)

The proposed distribution plan, in the instant case, falls squarely within the parameters of Annotations 625.0201 and 625.0235. Specifically, the Trust instrument provides for equal distribution of the Subject Property to Child A and Child B and the Trust instrument explicitly permits non-pro rata distribution. The proposed non-pro rata distribution will accomplish the

² Property tax annotations are summaries of the conclusions reached in selected legal rulings of State Board of Equalization counsel published in the State Board of Equalization's Property Tax Law Guide. (See Cal. Code Regs., tit. 18, § 5700 for more information regarding annotations.)

³ The statement "a distribution in kind may be made pro rata or non- pro rata" means that the trustee can either give the beneficiaries common ownership in each and every trust asset (pro rata) or allocate specific assets to individual beneficiaries (non-pro rata). (Letter to Assessors (LTA) No. 91/08, p.2.)

Trust's instructions of equal distribution between the two children in that Child B will receive cash in the same amount as the equity in the Subject Property that will be transferred to Child A. Finally, Child A, the beneficiary receiving the Subject Property, is not making the loan to the Trust to equalize the distribution. As such, consistent with the annotations discussed above, the proposed transfer of the Subject Property to Child A would qualify for the parent-child transfer exclusion, assuming all other requirements are met.

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. If you have any additional questions, please feel free to contact me.

Sincerely,

/s/ Mengjun He

Mengjun He
Tax Counsel III (Specialist)

MH: yg

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cc: Honorable Marc C. Tonnesen
President, California Assessors' Association
Solano County Assessor

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Mr. Benjamin Tang MIC:64
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