

M e m o r a n d u m

To: Mr. Verne Walton

Date: January 23, 1989

From: Eric F. Eisenlauer

Subject: Santa Barbara County – Proposition 58 and Three-Way 1031 Exchanges

This is in response to your memorandum of December 9, 1988 to Mr. Ken McManigal in which you request our review and analysis with respect to the following facts provided by the County.

1. Mr. Smith wants to buy property “Y” from Mr. Brown, the owner.
2. Mr. Smith wants to sell his property, property “X,” and use the proceeds to buy property “Y” from Mr. Brown.
3. Mr. Smith wants to do a 1031 exchange for property “Y” and defer his capital gains on property “Y.”
4. Mr. Brown does not want to buy property “X.”
5. Mr. Smith, Mr. Brown and Mr. White arrange for a concurrent, double escrow. In the first stage, Mr. Smith deeds property “X” to Mr. Brown and Mr. Brown deeds property “Y” to Mr. Smith. In the second stage, Mr. Brown deed property “X” to Mr. White, pursuant to agreement among the parties.
6. Transferring property “X” to Mr. Brown is necessary for Mr. Smith to qualify for a 1031 exchange. It was prearranged that property “X” was to be transferred to Mr. white in the same escrow.

If Mr. Smith and Mr. White are parent and child, the County asks whether the transfer to Mr. White qualifies for the Proposition 58 exclusion or whether the “straw man” transfer through Mr. Brown disqualifies Mr. White from benefitting from Proposition 58.

you know, Proposition 58 amended article XIII A of the California Constitution to provide among other things that the terms “purchase” and “change in ownership” do not include the purchase or transfer of the principal residence and the first \$1 million of the full cash value of other real property between parents and children. Chapter 48 of the Statutes of 1987 (AB 47) is the implementing legislation for Proposition 58. Chapter 48 added section 63.1 to the Revenue and Taxation Code (all statutory references are to the Revenue and Taxation Code unless otherwise indicated) and applies to purchases and transfers of real property completed on or after November 6, 1986.

The term "purchase" is defined by section 67 as "a change in ownership for consideration." "Change in ownership" is defined by section 60 "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." Thus, if a parent transfers to a child (or vice versa), an interest in real property as described in section 60, the transfer is excluded from change in ownership pursuant to Propostion 58 and section 63.1.

In Alderson v. C.I.R. (1963) 317 F.2d 790, the Internal Revenue Service argued that the transaction there involved could not be construed as constituting an exchange for purposes of Internal Revenue Code section 1031 because of the failure of one of the participants in a multiparty exchange to hold "real" interest in one of the properties sought to be exchanged. The court, relying on Mercantile Trust Company of Baltimore v. C.I.R. (1935) 32 B.T.A. 82 rejected that argument and held that there was no need to acquire a "real" interest in the property in question by assuming the benefits and burdens of ownership to make the exchange qualify under section 1031. The court stated at page 795:

"The Mercantile case appears to hold that one need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title solely for the purpose of exchange and accept title and transfer it in exchange for other like property, all as part of the same transaction with no resulting gain which is recognizable under Section 1002 of the Internal Revenue Code of 1954." (Emphasis in case.)

From the foregoing, it does not appear that for purposes of Internal Revenue Code section 1031 Mr. Brown was required to have any beneficial use of property "X." Moreover, from the facts presented, it appears that Mr. Brown was not intended to have any beneficial use of the property or any incident of ownership of the property other than the ability to transfer its title. His role was apparently only to receive title to property "X" in exchange for his transfer of property "Y" to Mr. Smith and to simultaneously transfer title to property "X" to Mr. White. Because of Mr. Brown's contractual obligation to convey property "X" to Mr. White, he did not have the right to the beneficial use of the property he received from Mr. Smith. That right passes from Mr. Smith (parent) through Mr. Brown to Mr. White (child). In our view, this transaction is similar to the financing mechanism used by the Department of Veteran Affairs wherein the Department purchases property from the owner (parent) and then sells the property to a Veteran (child) under a contract of sale. We concluded (see enclosed memorandum to Verne Walton dated September 19, 1988) that such a transaction is a transfer between parent and child for purposes of the parent-child exclusion.

For the foregoing reasons, we are likewise of the opinion that the transaction here in question is a transfer of property "X" from Mr. Smith (parent) to Mr. White (child) for purposes of the parent-child exclusion.

If we can be of further assistance in this matter, please let me know.

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cc: Mr. Richard H. Ochsner
Mr. Robert H. Gustafson