STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082
TELEPHONE (916) 323-7713
FAX (916) 323-3387
www.boe.ca.gov

August 22, 2000

In Re: **Change in Ownership – Stepped Transfer of Real Property from Parent to Children's Partnership.**

Dear Mr. :

This is in response to your letter of June 27, 2000, in which you requested our opinion concerning the application of the parent/child exclusion in Revenue and Taxation Code section 63.1 to a transfer of real property from a parent to children under a written unrecorded contract followed by the children's transfer of the property from themselves to children's partnership and the recordation of a deed from the parent to the children's partnership. For the reasons hereinafter explained, if the evidence establishes that beneficial ownership of the property transfers to children under the written unrecorded contract and only legal title transfers by deed to the partnership, then the deed presumption that parent is transferring the property to the partnership is rebutted. In such case, the transfer may be excluded under section 63.1 and the step transaction doctrine would not apply. The ultimate conclusion however, is a question of fact for the assessor's determination based on all relevant documents in existence at the time the deed is recorded.

The following proposed transaction is described for purposes of our analysis:

1. Partnership will be formed by two siblings, ("Children") with each child owning 50% of the partnership capital and profits interests. Partnership will acquire real property currently owned by the Parent through the following steps:

    a) Parent and children will execute a written unrecorded contract in which Parent agrees to transfer his real property to the children in equal shares in exchange for certain consideration;

    b) The contract will require that upon transfer to the children as individuals, the children will transfer the real property to the Partnership in exchange for proportional 50% interests;

    c) Parent will then execute and record a deed reciting the transfer from himself to the Partnership.

This issue is whether under the foregoing scenario, the present beneficial ownership of the real property transfers first from the parents to the children, making the transfer eligible for the parent/child exclusion, even though the deed memorializes the transfer from Parent to Partnership. A secondary issue is whether the subsequent transfer from the children to the Partnership under the proportional interest exclusion in section 62(a)(2) triggers the application of the step transaction doctrine.

Having discussed this transaction with the assessor's office, both parties agree to consider the opinion reached by the Board of Equalization's Legal Division as a recommendation for determining the proper application of the parent/child exclusion.

LAW AND ANALYSIS

Section 60 defines a 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." Under section 61(j), a change in ownership also includes, "The transfer of any interest in real property between a corporation, **partnership**, or other legal entity and a shareholder, **partner, or any other person**. This provision applies to all legal entities, and requires the assessor's determination of change in ownership when real property is transferred from individuals to a partnership, unless an exclusion or exception applies.

The parent/child exclusion in section 63.1, enacted by the Legislature to implement Article XIIIA, section 2(h) of the California Constitution ("Proposition 58"), provides that a "change in ownership" does not include the purchase or transfer of (1) the principal residence between parents and their children, and (2) the first $1 million of the full cash value of all real property other than a principal residence between parents and their children. To qualify for this exclusion, the transfer must be from an *eligible transferor* (i.e., a parent) to an *eligible transferee* (i.e., children). Under the basic definition in section 63.1(a), a "purchase" or "transfer" on which a claim may be filed is (1) "the purchase or transfer of real property which is the principal residence of an eligible transferor" or (2) "the purchase or transfer of the first one million dollars ($1,000,000) of full cash value of all other real property … between parents and their children." A legal entity, such as a partnership, is not included in the definitions of "children" or *eligible transferor* or *eligible transferee* in section 63.1(c).

In order to meet the forgoing requirement of section 63.1(a)(2) and have the property transfer directly from the Parent to the children, Parent and children will execute a written unrecorded contract, in which Parent will transfer the property to the children in equal shares in exchange for certain consideration to the Parent. The children will immediately thereafter transfer the real property to their Partnership in exchange for their proportionate partnership interests. The deed however, will expressly recite the transfer as being from the Parent to the Partnership. As such, the identity of the transferee in the deed will expressly contradict with the identity of the transferee in this contract; and Parent's transfer would be a transfer of real property *between a parent and a child*, eligible for the parent/child exclusion under section 63.1(a)(1), only if beneficial ownership of the property is transferred under the contract rather than the deed.

1. Would beneficial ownership of the property transfer under the unrecorded contract between Parent and children?

***Answer*: Yes, if there is sufficient evidence to rebut the deed presumption in Rule 462.200(b).**

For reasons unrelated to property tax considerations, you state that the children must take legal title to the property in the name of the partnership rather than as individuals. Although unrecorded, you state that the contract executed by the parties will constitute a valid conveyance of the property and will be specifically enforceable between Parent and children. While the recorded deed will state that the transfer is from the Parent to the partnership, you indicate that actual beneficial title to the property will transfer by the unrecorded contract. You suggest that the assessor rely on the unrecorded contract as the date that beneficial ownership transfers.

The date upon which beneficial title to the property transfers is clearly described in Rule 462.260. Subdivision (a)(1) provides that in sales transactions, "Where the *transfer is evidenced by recordation of a deed* or other document, the date of recordation shall be rebuttably presumed to be the date of ownership change. This presumption may be rebutted by evidence proving a different date to be the date all parties' instructions have been met in escrow or the date the agreement of the parties became specifically enforceable." With respect to an unrecorded document, subdivision (a)(2) provides that, "Where the *transfer is accomplished by an unrecorded document*, the date of the transfer document shall be rebuttably presumed to be the date of ownership change. This presumption may be rebutted by evidence proving a different date to be the date all parties' instructions have been met in escrow or the date the agreement of the parties became specifically enforceable."

In situations such as this, where there is both an unrecorded transfer document and a recorded deed, the rule requires that the recorded deed be used as evidence for the date of the change in ownership of the property. This requirement however, is based on a rebuttable presumption, that allows the taxpayer to submit other evidence proving that the parties intended a different date as the transfer date. Rule 462.200(b) states the type of evidence required to rebut the deed presumption.

> **(b) Deed Presumption.**
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> * * *
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> In overcoming this presumption, consideration may be give to, but not limited to, the following factors:
>
> (1) The existence of a written document executed prior to or at the time of the conveyance in which all parties agree that one or more of the parties do not have equitable ownership interests.
>
> (2) The monetary contribution of each party. The best evidence of the existence of any factor shall be an adjudication of the existence of the factor reflected in a final judicial finding, order, or judgment. Proof may also be made by declarations under

> penalty of perjury (or affidavits) accompanied by such written evidence as may reasonably be available, such as written agreements, canceled checks, insurance policies, and tax returns.

These provisions are consistent with Evidence Code section 662 which states that the owner of the legal title to property is presumed to be the owner of the full beneficial title and that the presumption may be rebutted only by clear and convincing proof. Proof that is "*clear and convincing*" constitutes evidence that is explicit and unequivocal that beneficial title transferred to a person or entity other than those named in the deed, *or that title is transferred at a point in time distinct from the date of delivery of the deed*. (1 Witkin, California Evidence, 3rd Ed. 1986, Sec. 160.)

It has been our position that where the parties have executed a written contract or partnership agreement, to define and describe their relationship and their rights to exercise ownership interests over the property, as sellers and buyers or as partners, the terms of that contract or agreement should be given the great weight. Certainly, when the contract or agreement is executed by the parties *before* or at the time of the delivery and/or recordation of a deed, it should be considered as highly relevant evidence for purposes of determining the true intent of the parties in the transfer. In fact, where a written agreement exists, the parties may not avoid liability or any of the other incidents of partnership/membership with regard to the property held in the partnership[1] (Witkin, Summary of California Law, 9th Ed. 1989, p 423)

In order to overcome the presumption that beneficial ownership transfers under the recorded deed, the specific provisions in the unrecorded contract, the parties' actions pursuant to the contract, and other evidence, if any, must establish to the satisfaction of the assessor that the deed is relevant only for purposes of transferring bare legal title. Where, as you state here, there is a valid written contract executed prior to or at the time of the conveyance, in which all parties agree that one or more of the parties (i.e., the Parent) do not have equitable ownership interests, but the children do, the evidentiary burden of proof required by Rule 462.200(b)(1) is met. If, in addition to the contract, there is evidence that valuable consideration was paid by each child, or other evidence of a bona fide transfer, such as declarations or affidavits made under penalty of perjury, canceled checks, insurance policies, and tax returns establishing the children's beneficial interest in the property, then the evidentiary burden of proof required by Rule 462.200(b)(2) is met.

When and how the beneficial ownership of the property transfers is a question of fact for the assessor. A taxpayer claiming the benefit of an exclusion from change in ownership has the burden of establishing to the satisfaction of the assessor that he or she qualifies for the exclusion. In cases where formal recorded documents, such as deeds, fail to contain complete terms which are consistent with the taxpayer's claim, then the assessor is entitled to require that the taxpayer's representations be established by other clear and convincing proof.

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[1] We have opined in the past, for example, that where there is a written partnership agreement, that agreement is controlling for all purposes in determining property tax consequences on and after its effective date (even where the "Statement of Partnership" has been filed with the county recorder per Corporations Code section 15010.5). (See Annotation No. 220.0468, attached.) Thus, the partners cannot escape the consequences of their agreement as the controlling document in establishing the names of the partners, the nature of their interests, the assets owned by the partnership, the business purpose, and other terms of the partnership entity they created.

2. If beneficial ownership of the property transfers from Parent to children by unrecorded contract, does the second transfer by the children to the partnership trigger the application of the step transaction doctrine?

***Answer*: No.**

Even if the assessor determines that the Parent did transfer beneficial ownership of the property to the children by the unrecorded contract rather than by deed, an additional concern could be the possible application of the step transaction doctrine. The proposal you submit is structured in two steps rather than one, in order "*to qualify for the parent/child exclusion*." The first transfer is from the Parent to the children (assuming the deed presumption is rebutted) and constitutes a 100% change in ownership of the property under section 61(f), except for the application of the parent/child exclusion in section 63.1. The second transfer, under the terms of the unrecorded contract, is from the children to the partnership, resulting in a 100% change in ownership of the property per section 61(j), except for the application of the proportional interest exclusion in section 62(a)(2).[2]

The "step transaction doctrine" has been applied to property tax transfers when unnecessary steps are taken in close proximity merely to circumvent the intent of the change in ownership statutes. In such case, the "substance of the transaction, rather than the form" will determine if a change in ownership has actually occurred. (Shuwa Investment Corp. v. County of Los Angeles (1991) 1 Cal. App.4th 1635).[3] The type of steps which must be taken to transfer property from a parent to a partnership owned by the children in order to utilize the parent/child exclusion are: (1) a transfer of real property from parent to the children using either the parent/child exclusion in section 63.1 or the de minimis exclusion in section 65; and (2) a proportional interest transfer of the property by the children to the partnership under section 62(a)(2).

Except for the uncodified statement of legislative intent at the end of section 63.1 (Stats. 1987, Ch. 48), *prohibiting the assessor from applying the step transaction doctrine* to entity transfers involving parents and their children, the two steps would be collapsed together and all of the property would be reappraised as a change in ownership. The following quoted language extends the parent/child exclusion and prohibits the application of the step transaction doctrine to "stepped" transfers taken by parents and children attempting to utilize the exclusion where a partnership is involved:

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[2] The section 62(a)(2) exclusion from change in ownership applies to proportional interest transfers between individuals and a legal entity and between a legal entity and individuals, which result solely in a change in the method of holding title to the real property and the proportional ownership interests of the transferors and transferees, in each and every piece of real property remain the same after the transfer.

[3] In Shuwa, the court set forth three possible tests for the application of the step transaction doctrine. The "end result test" looks at the various steps as component parts of a single transaction. The "interdependence test" focuses on whether one step would have been taken without any of the other steps apart from the parties' intent to utilize an exclusion. The final test, known as the "binding commitment test," looks at whether the structure of the transactions is such that taking the first step, in effect, constitutes a binding commitment to follow through with the entire transaction, e.g., the parties agree to specified transfers in a certain chronological order, beginning with the first, in order to complete the entire transaction.

> "... it is the intent of the Legislature that the provisions of section 63.1 of the Revenue and Taxation Code shall be liberally construed in order to carry out the intent of Proposition 58 on the November 4, 1986, general election ballot to exclude from change in ownership purchases or transfers between parents and their children described therein. Specifically, transfers of real property from a corporation, partnership...to an eligible transferor or transferors, where the latter are the sole beneficial owner or owners of the property, shall be fully recognized and shall not be ignored or given less than full recognition under a substance-over-form or step transaction doctrine, where the sole purpose of the transfer is to permit an immediate retransfer from an eligible transferor or transferors to an eligible transferee or transferees which qualifies for the exclusion from change in ownership provided by section 63.1. Further, transfers of real property between eligible transferors and eligible transferees shall also be fully recognized when the transfers are immediately followed by a transfer from the eligible transferee or eligible transferees to a corporation, partnership, trust, or other legal entity where the transferee or transferees are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property, if the transfer between eligible transferors and eligible transferees satisfies the requirements of section 63.1. Except as provided herein, nothing in this section shall be construed as an expression of intent on the part of the Legislature disapproving in principle the appropriate application of the substance-over-form or step-transaction doctrine. (Emphasis added.)

Based on the foregoing, it has also been our position that the statement of intent prohibits the application of the step transaction doctrine in various situations where the eligible transferees own all or part of the partnership and the eligible transferors own none (or the balance). See the attached legal opinion cited as Annotation No. 625.0193 (Eisenlauer Letter 4/5/88), where on pages 3-4, Mr. Eisenlauer advises that

> "Although the foregoing language [the statement of legislative intent] specifies that the step transaction doctrine would not be applicable where the transferees are the sole owners of the entity, we are of the opinion that a liberal construction of section 63.1 would preclude the application of the step transaction doctrine under the facts of your last alternative [parents and children both transferred property into the limited partnership], i.e., where the eligible transferees own part of the limited partnership and the eligible transferors own the balance of the limited partnership."

In addition, he concludes that "subsequent transfers of partnership interests would not constitute a change in ownership" of the partnership property unless one person or entity obtained a majority ownership interest in the partnership (section 64(c)) or the original coowners transferred cumulatively more than 50% of the partnership interests (section 64(d)). See also Annotation No. 625.0191 (Lambert Letter 7/10/89) and Annotation No. 625.0190 (Eisenlauer Letters, 11/21/90 and 1/3/91.))

The situation you propose here was discussed in *Penner v. County of Santa Barbara* (1995), 37 Cal.App.4th 1672. The court explained that the statement of legislative intent would have been applicable to the facts of that case had the taxpayer structured her transaction in two steps instead of one. The court specifically discussed the two steps on page 1678, as follows:

> "The parties agree that Penner could have avoided a reassessment if she had transferred the property to herself and her children and then to the partnership. Had she done so, the first step of this theoretical transaction would be exempt under Section 2(h). The second step would not constitute a 'change in ownership' for purposes of section 2(a) if the transfer changed only the method of holding title to the property and not the proportional ownership interests of the family members."

Since Penner did not structure her transaction as described however, the court refused to conclude that the tax consequences should be determined by pretending that she took steps which, in reality, she did not. As in this proposal, the facts of that case relate to the steps necessary for parents and children to utilize the exclusion when forming a partnership and transferring the property to that partnership.

In summary, if the unrecorded contract and other documents submitted to the assessor establish that the date of the unrecorded contract is the date that beneficial ownership of the property actually transferred to the children, the transfer may be excluded as a parent/child transfer under section 63.1, providing other requirements of section 63.1 are met. The second transfer, from the children to the Partnership in exchange for proportionate shares in the Partnership, would qualify for the exclusion in section 62(a)(2). Although the two steps would indicate the possible application of the step transaction doctrine, the uncodified statement of legislative intent at the end of section 63.1 leads to a conclusion that the doctrine is not applicable. However, the assessor's determination in these matters is final, since these are primarily questions of fact to be determined by him.

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

Sincerely,

/s/ Kristine Cazadd

Kristine Cazadd
Senior Tax Counsel

KEC:tr
prop/prec/parchild/00/08kec

Attachments

cc:

Mr. Richard Johnson, MIC:64
Mr. David Gau, MIC:64
Ms. Jennifer Willis, MIC:70