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Executive Director

December 8, 2005

Re: *Petition to Amend Rule 462.180*

Dear Mr. :

This is in response to your August 4, 2005 letter addressed to Ms. Selvi Stanislaus, Acting Assistant Chief Counsel, in which you requested a written opinion concerning the application of the parent-child exclusion to certain transfers between parents and their children. As discussed in detail below, we conclude that the transfers at issue do not constitute a change in ownership as defined in Revenue and Taxation Code¹ section 60.

FACTS

STEP 1 - Husband (H) and Wife (W), as coowners, transfer Blackacre to limited liability company (LLC), each receiving a 50 percent membership interest in LLC.²

STEP 2 - H and W each gift one-half of their interest in the LLC to their Child (C), so that H and W now each own 25 percent and C owns 50 percent of the membership interest in the LLC.

STEP 3 - The LLC transfers Blackacre to H, W and C in proportion to their respective membership interests in the LLC, as tenants in common.

STEP 4 - H and W transfer one-half of their respective interests in Blackacre to C, with the result that H and W now each own a 12.5 percent interest in Blackacre and C owns a 75 percent interest in Blackacre.

STEP 5 - H, W and C transfer Blackacre to the LLC, each receiving the same proportional membership interest in the LLC, namely, H and W own 12.5 percent each, and C owns 75 percent.

STEP 6 - H and W transfer their remaining 12.5 percent interests in the LLC to C, with the result that C becomes the sole owner of the LLC.

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

² Our understanding is that that the transfer at issue involves a principal residence as defined in section 63.1, subdivision (a)(1) or the transfer of property other than a principal residence, which does not exceed the \$1,000,000 dollar full cash value limit under section 63.1, subdivision (a)(2).

APPLICABLE LAW

Article XIII A, section 2 of the California Constitution allows the reassessment of property only upon certain conditions. One such condition is a “change in ownership.” A “change in ownership” is defined in 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.”

Section 64, subdivision (a) provides that, generally, transfers of interests in legal entities do not constitute a change in ownership of the real property owned by the legal entities. However, section 64, subdivision (c) provides that when any person or entity obtains direct or indirect control of more than 50 percent of stock or other ownership interests, a change in ownership of the real property occurs. Section 61, subdivision (j) also provides that, “change in ownership” includes, but is not limited to, “[t]he transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner, or any other person.”

Section 62, subdivision (a)(2) provides an exclusion from “change in ownership” for transfers between individuals and a legal entity or between legal entities that result “solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and the transferees..., in each and every piece of real property transferred, remain the same after the transfer.” Pursuant to section 64, subdivision (d), as a consequence of such a transfer, the transferors, holding ownership interests in the legal entity immediately after the transfer, become “original coowners.” Subsequent transfers of the original coowners’ ownership interests representing cumulatively more than 50 percent of the total interests in the entity result in a change in ownership of the property that was previously excluded under section 62, subdivision (a)(2).

Another exclusion from change in ownership applicable herein is provided by section 63.1 which excludes certain purchases or transfers, between parents and their children, of real property. Section 63.1, subdivision (a) provides in relevant part:

(a) Notwithstanding any other provision of this chapter, a change in ownership shall not include either of the following purchases or transfers for which a claim is filed pursuant to this section:

(1) The purchase or transfer of *real property* which is the principal residence of an eligible transferor in the case of a purchase or transfer between parents and their children.

(2) The purchase or transfer of the first one million dollars (\$1,000,000) of full cash value of all other *real property* of an eligible transferor in the case of a purchase or transfer between parents and their children.
[Emphasis added.]

Analysis of Individual Steps

Step 1 - H and W, as coowners, transfer Blackacre to LLC, each receiving a 50 percent membership interest in LLC.

In this step, H and W are transferring real property, Blackacre, to the LLC, a legal entity and each receives, in exchange, an ownership interest in the LLC exactly proportional to their ownership interests in Blackacre prior to the transfer. Prior to the transfer, H and W each owned

a 50 percent interest in Blackacre. After the transfer, H and W each own a 50 percent interest in LLC which owns 100 percent of Blackacre.

Since this transfer results solely in a change in the method of holding title to the property in which the proportional ownership interests of the transferors and transferees remain the same after the transfer, the section 62, subdivision (a)(2) exclusion applies and no change in ownership occurs; however, H and W become “original coowners” under section 64, subdivision (d) and all subsequent transfers of H and W’s ownership interest in the LLC are cumulated for purpose of determining whether more than 50 percent of the total interest in the legal entity has been transferred by any of the original coowners.

Step 2 - H and W each gift one-half of their interest in the LLC to their C, so that H and W now each own 25 percent and C owns 50 percent of the membership interest in the LLC.

In this step, H and W, original coowners, are transferring 50 percent of their legal entity interest to C. Since H and W are original coowners, any transfer of their ownership interest in LLC is cumulated to determine whether a change in ownership occurs under section 64, subdivision (d). Since H and W transfer only 50 percent of their membership interest in LLC, no change in ownership occurs under subdivision (d). Furthermore, since C acquired only 50 percent of the membership interests in LLC, no change in ownership occurs under section 64, subdivision (c).

Since there is no change in ownership pursuant to section 64, subdivisions (c) and (d), this transfer of LLC interests is excluded from change in ownership under section 64, subdivision (a) which excludes transfers of legal entity interests from change in ownership when there is no change in control and when “original coowners” have not cumulatively transferred more than 50 percent of their legal entity interest. We note that the parent child exclusion provided in section 63.1 does not apply to transfers of interests in a legal entity.

Step 3 - The LLC transfers Blackacre to H, W and C in proportion to their respective membership interests in the LLC, as tenants in common.

In this step, the LLC is transferring real property to H, W, and C. Prior to the transfer H and W each own a 25 percent membership interest and C owns a 50 percent membership interest in LLC. The LLC owns 100 percent of Blackacre. After the transfer, H and W will each own a 25 percent interest in Blackacre while C will own a 50 percent interest in Blackacre. Thus, H, W, and C’s proportional ownership interests in Blackacre have not changed.

Since this transfer results solely in a change in the method of holding title to the property in which the proportional ownership interests of the transferors and transferees remain the same after the transfer, the section 62, subdivision (a)(2) exclusion applies and no change in ownership occurs. Section 64, subdivision (d) does not apply because that section applies only to transfers of ownership interests in a legal entity. Furthermore, the “original coowner” taint disappears

when Blackacre is transferred by the LLC to H, W, and C. In other words, H and W are no longer original coowners with respect to their membership interests in the LLC.

Step 4 - H and W transfer one-half of their respective interests in Blackacre to C, with the result that H and W now each own a 12.5 percent interest in Blackacre and C owns a 75 percent interest in Blackacre.

In this step, H and W are transferring real property, Blackacre, to C, their child. Since C is H and W's child, and Blackacre is real property, the section 63.1 parent-child exclusion applies assuming that Blackacre is a principal residence or that Blackacre is not a principal residence but the transfer does not exceed the first \$1,000,000 dollar full cash value limit as set forth in section 63.1, subdivision (a)(2).

Step 5 - H, W and C transfer Blackacre to the LLC, each receiving the same proportional membership interest in the LLC, namely, H and W own 12.5 percent each, and C owns 75 percent.

In this step, H, W, and C are transferring real property, Blackacre, to LLC, a legal entity and each receives, in exchange, an ownership interest in the LLC exactly proportional to their ownership interests in Blackacre prior to the transfer. Prior to the transfer H and W each own a 12.5 percent interest in Blackacre while C owns a 75 percent interest in Blackacre. After the transfer, LLC owns 100 percent of Blackacre. H and W each own a 12.5 percent membership interest in LLC while C owns a 75 percent membership interest in LLC.

Since this transfer results solely in a change in the method of holding title to the property in which the proportional ownership interests of the transferors and transferees remain the same after the transfer, the section 62, subdivision (a)(2) exclusion applies and no change in ownership occurs; however, H, W and C become new "original coowners" under section 64, subdivision (d) and all subsequent transfers of their membership interests in the LLC are cumulated for purposes of determining whether more than 50 percent of the total legal entity interest has been transferred.

Step 6 - H and W transfer their remaining 12.5 percent interests in the LLC to C, with the result that C becomes the sole owner of the LLC.

In this step, H and W each transfer their 12.5 percent legal entity interests to C. H, W, and C are original coowners but have cumulatively transferred only 25 percent of their membership interests in LLC. Thus, no change in ownership occurs under section 64, subdivision (d). Furthermore, since C owned more than a 50 percent ownership interest in the LLC prior to the transfer, no change in control occurs under section 64, subdivision (c).

Since there is no change in ownership pursuant to section 64, subdivisions (c) and (d), this transfer of LLC interests is excluded from change in ownership under section 64,

subdivision (a) which excludes transfers of legal entity interests from change in ownership when there is no change in control and when “original coowners” have not cumulatively transferred more than 50 percent of their legal entity interest. We note again that the parent child exclusion provided in section 63.1 does not apply to transfers of interests in a legal entity.

Step Transaction Doctrine

The step transaction doctrine is not applicable to the transfers at issue. We note that the “step transaction doctrine” is applied when a series of transfers are made merely to avoid reappraisal; in which case, the “substance of the transaction, rather than the form” will determine if a change in ownership has actually occurred. (See *Shuwa Investment Corp. v. County of Los Angeles* (1991) 1 Cal.App.4th 1635.)

However, section 2 of 1987 California Statutes, Chapter 48, an uncodified part of section 63.1 designated as a note (Note), describes a series of transactions to which the step transaction doctrine should not be applied. The Note explains the legislative purpose underlying section 63.1. It states that:

... 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 ... legal entity 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 ... 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.

Based on the foregoing, the step transaction doctrine does not apply to transfers that are consistent with the Note, that is, transfers of real property and legal entity interests between parents and children. (See Property Tax Annotations 625.0190, 625.0191, and 625.0192.) Thus, although the substance of the steps outlined above ultimately results in the transfer of a 100 percent membership interest in LLC owned by H and W to C, the Note precludes the application of the step transaction doctrine to the transfers at issue.

Property Tax Rule 462.180, Subdivision (d)

We agree with your statement that Property Tax Rule 462.180, subdivision (d) should not preclude the application of the parent-child exclusion even though it is not specifically listed in that subdivision. Subdivision (d) implements various change in ownership statutes related to transfers of ownership interests in legal entities. As to the transfers at issue, as discussed above, each transfer is excluded from the definition of change in ownership either as a qualifying

parent-child exclusion under section 63.1, a transfer of an ownership interest in a legal entity under section 64, subdivision (a), or a transfer of a proportional ownership interest under section 62, subdivision (a)(2). Furthermore, consistent with the legislative intent expressed in the Note, the step transaction doctrine is not applicable to such transfers.

Furthermore, subdivision (d)(2) only addresses transfers of more than a 50 percent interest in a legal entity. Specifically, it provides that interspousal transfers excluded under section 63, transfers into qualifying trusts excluded under section 62, subdivision (d), and proportional transfers excluded under section 62, subdivision (a)(2) shall not be cumulated or counted to determine a change in ownership. We note that the reason why subdivision (d)(2) does not list the parent-child exclusion under section 63.1 is because the parent-child exclusion only applies to transfers of interests in real property, not transfers of interests in legal entities. Therefore, even though subdivision (d)(2) does not list the parent-child exclusion, as to the transfers at issue, such transfers do not constitute a change in ownership as defined in section 60.

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

Sincerely,

/s/ Richard S. Moon

Richard S. Moon
Tax Counsel

RM:eb
Prec/ParChld/05/534-rm

cc: Honorable
County Assessor

Mr. David Gau, MIC:63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Todd Gilman, MIC:70