TRIPPING OVER THE GOPHER HOLES: AN ESTATE'S PLANNER'S GUIDE TO PROPOSITION 13[%]

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INTRODUCTION

As estate planners we devote the vast majority of our attention to the federal transfer tax system. We spend far less time on income taxes, although we do pay some attention to those taxes. We spend very little of our time on property taxes. This oversight is peculiar when we consider that the real property tax is quite often the client's *first* concern. When describing the benefits of transferring the family residence to a revocable trust, or a qualified personal residence trust, an invariable question from the client is whether the transfer will result in a property tax re-assessment. Most estate planners can respond confidently to those questions. Our confidence is less certain, however, when we discuss real property transfers to family limited partnerships and limited liability companies. If we are candid, not all of our answers in this area provide our clients with the proper degree of knowledge necessary to make an informed decision.

As Frayda L. Bruton highlighted so well in her article in the preceding issue of the *Quarterly*,[1] glaring inconsistencies exist between the California constitution, the enabling legislation, and the day-to-day enforcement of Proposition 13. Article XIIIA of the Constitution has been in effect for nearly 20 years, yet it has

been only recently that its estate planning questions have been recognized, and occasionally resolved.

CHANGE IN OWNERSHIP AND EXCLUSIONS

Without a change in ownership (*CIO*) property taxes may not be increased more than 2% over the assessed value of the previous assessment year.[2] Upon a CIO, however, a re-appraisal of the property to "full cash value" occurs.[3] At this time "full cash value equals fair market value.[4] The resulting re-assessment generally causes increased property taxes, although with the decline in California real estate in this decade that conclusion does not always follow. In the years following re-assessment, however, "full cash value" may be considerably less than fair market value.[5] This result can have significant implications when using one of the exclusions discussed later in this article.

Section 60 defines "change in ownership" as follows:

> A "change in ownership" means 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.[6] (emphasis supplied)

Implementation and interpretation of this deceivingly simple phrase has neither been straight-forward nor consistent.[7] The exclusions are similarly misleading in their apparent simplicity.[8] The interpretive problems multiply when exclusions are applied sequentially; for example, an interspousal transfer, followed by a joint tenancy transfer, followed by a parent child transfer.

The exclusions discussed in this article are the following:

1. Interspousal transfers under Revenue and Taxation Code section 63.

2. Transfers between parent and child under Revenue and Taxation Code section 63.1 and the corresponding, limited expansion to transfers between parent and grandchild.

3. Transfers among ***original*** joint tenants under Revenue and Taxation Code section 65.

4. Transfers where the "owners" remain the same and have the same percentages of "ownership" before and after the transfer as permitted by Revenue and Taxation Code section 62.

5. Transfers within an entity under Revenue and Taxation Code section 64(a), as qualified by subsections(c) and (d).

Basic Sources and Forms

The applicable statutory and regulatory structure is found in Article XIIIA of the California Constitution, sections 60 ***et. seq.*** of the Revenue and Taxation Code,[**] and Title 18 of the California Administrative Code. These provisions, unfortunately, serve more as a framework of general principles than as specific answers for particular cases. Only in the last 5 years has useful case law emerged, although most of these decisions have focused on the application of the "step transaction" doctrine in the context of business entities.

No treatise is readily available to the practitioner to help resolve all or even most of the questions. The primary source of guidance is the State Board of Equalization ("SBE"). The SBE has

[**] All sections cited hereafter are to the California Revenue and Taxation Code, unless specifically stated otherwise.

the responsibility to "prepare and issue instructions to assessors designed to provide uniformity through the state and its local taxing jurisdictions in the assessment of property for the purpose of taxation."[9] The SBE issues "Letters to Assessors" (referred to as *LTA* in this article) for the purpose of providing rules so that the "law" may be applied uniformly.

In addition to LTA, the SBE provides written responses to specific questions from assessors, legislators, and practitioners. These responses concern the view of the SBE to the specific question posed. In this article those responses are referred to as *Correspondence*.

LTA are entitled to "considerable weight."[10] *Correspondence*, in contrast, is advisory only. Consequently, individual County Assessors feel free to disagree with the SBE when answering specific questions.

The authors suggest that a practitioner structuring a transaction with substantial exposure to real property taxes, and uncertain of the result, first solicit *Correspondence* from the SBE. The authors also suggest that the practitioner discuss the details of the anticipated transaction with the local Assessor in advance, in order to gain some level of confidence as to the Assessor=s treatment of the transaction.

The practitioner also should not hesitate to make effective use of the Preliminary Change of Ownership Report Form ("PCOR") when filing the transfer documents.[11] A well reasoned argument on the PCOR explaining why the transfer should be excluded from a CIO

can be very helpful in avoiding the Assessor's issuance of a Notice of Intent to Re-Assess the Property. Generally, once the Notice of Intent to Re-Assess the property issues, it is too late to stop the re-assessment process, and the taxpayer is compelled to pay the tax, and then to file a Claim for Refund. Educating the assessor about the transfer, and the taxpayer's justification for excluding this transaction from a CIO, will be a significant service to the client if it avoids the need to file for a Claim for Refund. The appeals and refund procedure can take years to resolve, during which time the client is obligated to pay the increased property taxes. Accordingly, using the PCOR to avoid the process can be time well spent.

INTERSPOUSAL TRANSFERS

Qualifying transfers between husbands and wives are excluded from the definition of a CIO.[12] Transfers falling within Section 63 include transfers of real property, or interests in real property, and transfers through the medium of a trust. Section 63 includes as a transfer of an interest in real property joint tenancy transfers, receipt of the deceased spouse's community property interest, gift of a life estate,[13] or transfers in connection with dissolution of the marriage.[14]

To determine whether a transfer through the medium of a trust qualifies for the interspousal exclusion first requires analyzing the section 60 definition of CIO. To claim the exclusion, the spouse, "After the transfer...[must] possess the *present ownership* [of the property]" or must have "the *beneficial use thereof*, the

value of which is *substantially equal* to the value of the fee interest."[15] (emphasis supplied) A transfer of a complete interest in the real property by spouses into a joint revocable trust where each continues to hold the power to revoke[16] for the individual's benefit therefore qualifies for this exclusion.

A transfer to an irrevocable trust created after the death of the first spouse may have a less self-evident answer. Typical examples of these trusts are "Bypass" Trusts, intended to shelter the unified credit equivalent, or "Marital Deduction" Trusts, intended to hold that amount of the property in excess of the unified credit equivalent. In these circumstances the operative analysis turns on determining the requisite *qualifying beneficial* interest.[17]

A transfer of real property into a marital deduction trust which is a qualified terminable interest property (QTIP) trust under the Internal Revenue Code[18] qualifies because the surviving spouse has a beneficial interest.[19] QTIP Trusts require the surviving spouse to receive all income for life, and restrict distribution of principal to the surviving spouse during the survivor's life. The surviving spouse also must have the power to require the Trustee to make the property productive.[20]

The answer may not be as clear with property transferred to a Bypass Trust. This trust is intended to avoid, or minimize, federal estate taxes at the death of the first spouse, and therefore the survivor may not have an income interest, or the

survivor may share the income interest with several other beneficiaries, such as the children.

To illustrate these issues, consider the effect of the following examples on a typical community property trust that upon the first death establishes a Bypass Trust funded exclusively with Greenacre. Greenacre is a parcel of California real property having a full cash value equal to its present fair market value of $600,000. Assume that one of spouses died in 1996.

In our first example, the trust instrument provides for all income to be paid to the surviving spouse quarter-annually, with principal distributions to the survivor restricted to health, support, and maintenance; i.e. an ascertainable standard. The instrument further provides that upon the surviving spouse's death, Greenacre will be transferred to the children of the decedent by a prior marriage.

The surviving spouse has an income (*beneficial*) interest for life which is *substantially equal* to the value of the fee interest. This interest is comparable to the survivor's interest in the QTIP Trust, and therefore the transfer of Greenacre to the Bypass Trust will not be a CIO.

Distribution of principal to the survivor is immaterial to claiming the exclusion, whether pursuant to an ascertainable standard, or subject to a discretionary standard. Similarly, the identity of the remainder beneficiaries after the death of the survivor is irrelevant to the application of the exclusion.

In our second example, the trust instrument provides for income to be distributed by the Trustee to the surviving spouse pursuant to an ascertainable standard. The Trustee may also distribute principal to the surviving spouse, or the decedent's issue, pursuant to an ascertainable standard.

Under this standard the surviving spouse is not guaranteed receipt of all trust income, because the power to distribute according to an ascertainable power is the implicit power to accumulate income. Nevertheless, the survivor is considered the sole owner of the income interest. Possessing the exclusive income interest should be sufficient to qualify for the spousal exclusion. The transfer to the Bypass Trust should not a CIO because the surviving spouse retains an interest *substantially equal* to the value of the fee interest, even though in this circumstance *substantially equal* is not *equal*. The power of a trustee to distribute *principal* among the spouse and other persons does not prevent application of the interspousal exclusion because the other persons only have a "mere expectancy" in the receipt of principal[21].

In our third example, the trust instrument provides for income to be distributed to the surviving spouse and to issue of the spouses by the Trustee pursuant to a discretionary "sprinkling" power. In this circumstance the surviving spouse is no longer the sole beneficiary. The surviving spouse may receive all, some, or none of the trust income. The surviving spouse no longer has a *beneficial interest* which is *substantially equal* to the value of the fee interest,[22] and therefore a CIO has occurred. Whether the

surviving spouse has the sole beneficial interest is the critical inquiry when claiming the interspousal exclusion.

An ascertainable power can be limited to the survivor, and therefore should not affect claiming the interspousal exclusion. In contrast, a sprinkling power will include more persons than simply the surviving spouse, and for that reason will generally prevent the trustee from claiming the interspousal exclusion for Greenacre.

The estate planner needs to communicate these consequences to the client if a decision has been made to give the trustee a sprinkling power over the income of the Bypass Trust. Giving the power to a Trustee to sprinkle income may be beneficial in avoiding an increase in the surviving spouse's estate, and the survivor=s estate taxes. Nevertheless, the client should understand that this benefit will come at the cost of losing the property tax exclusion.

If the only real property in the estate is the principal residence, however, this problem often can be remedied by allocating the decedent's interest in the residence to the QTIP Trust. If the client (or the client=s lawyer) is not aware of this nuance, the result may prove an unfortunate surprise after the first death to learn that the real property assessed at far below market value must undergo a CIO because of the transfer to the Bypass Trust.

Another area of uncertainty concerns interspousal transfers of interests in entities owning real property. Section 63 does not

make clear whether such transfers qualify for the interspousal exclusion. Consider the following example:

> Husband and Wife contribute Greenacre to Partnership P, each receiving a 50% interest in P for the exchange. Subsequently Husband gifts 1% of his interest in P to Daughter and Wife gifts 1% of her interest in P to Son. Husband and Wife then convey each of their respective 49% partnership interests to a joint revocable trust. Husband dies and his 49% partnership interest is transferred to the Bypass Trust, of which Wife is the sole income beneficiary.

Does the transfer of the 49% interest to the Bypass Trust qualify for the interspousal exclusion? As Frayda Bruton observes[23], a certain answer to this question does not yet exist. The SBE construes the California Constitution[24] expansively in these circumstances to include interests in legal entities. This reading is expansive because the strict language of the Constitution[25] does not include transfers of interests in legal entities. The SBE bases its interpretation on court decisions resolving similar issues in property tax matters.[26] The SBE also relies on the language of Section 63, which begins "[n]otwithstanding any other provisions of this chapter". The SBE opines that Section 63 is intended to be interpreted liberally in favor of the interspousal exception.[27] Nevertheless, the SBE acknowledges the ambiguity of the Constitutional section, and the county assessor's resulting autonomy to make contrary decisions.[28]

The reader will note that this example is similar to many current estate plans. If the 49% partnership interest transferred to the Bypass Trust does not qualify for the interspousal exclusion, then the 49% partnership interest transferred to the Bypass Trust *plus* the partnership interest already held by Wife will give Wife ownership of more than 50% of the partnership, thereby resulting in a CIO.[29]

In our fifth example, the trust instrument provides for income to be distributed by the Trustee to the surviving spouse pursuant to an ascertainable standard. The Trustee may also distribute principal to the surviving spouse, or the decedent's issue, pursuant to an ascertainable standard. In addition, the surviving spouse has the noncumulative power to withdraw annually the greater of 5% of the trust corpus or $5,000.

Under federal estate tax law a failure to exercise the power to withdraw corpus has no effect except in the year of death.[30] The SBE has applied the change in ownership rules to reach a contrary conclusion. For purposes of interspousal transfers, the lapse of a "5&5 power" is the equivalent of the exercise of the power, even if the power is noncumulative.[31] The SBE interpretation may be inexplicable, but it is the (unpleasant) current reality. As will be seen in the discussion concerning the Parent Child Exclusion this interpretation creates real problems.

EXCLUSIONS BECAUSE OF PARENT-CHILD TRANSFER

On November 6, 1986, California voters passed Proposition 58 to give themselves some relief from the strict CIO rules of Proposition 13. The voters approved exclusion of transfers between parents and children of a personal residence *plus* $1,000,000 of full cash value of other real property transfers per transferor. Proposition 58 is codified in Section 63.1.

The general language of Proposition 58 and section 63.1 is remarkable for its liberality. By using $1,000,000 of full cash value[32], the statute allows property with a current *fair market value* substantially greater than $1 million to qualify for the exclusion. Since increases in assessments are limited to no more than 2% per year, over a period of time Full Cash Value will tend to lag behind fair market value. For instance, property assessed as of March 1, 1975 (the inception date for Proposition 13) may have a Full Cash Value assessed substantially below Fair Market Value. The ability to transfer property worth significantly more than its assessed value confers a substantial economic advantage on the younger generation.

The $1,000,000 is available for each "eligible transferor."[33] An "eligible transferor" is "a parent or child of an eligible transferee".[34] Accordingly, transfers may be between parents and children, or between children and parents.[35] A "Transfer" includes "but is not limited to....any transfer of the beneficial ownership of property from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust".[36]

Unfortunately, the drafters of Proposition 58 continued the same pattern found in Proposition 13. The drafters of Proposition 58 also limited its scope to exclude "legal interests." Moreover, the language of the parent-child exclusion creates a narrower use than that which occurs with the interspousal exclusion: "real property" is defined specifically to exclude "any interest in a legal entity."[37]

This restrictive language seems at odds with the Legislature's expressed intent that Section 63.1 is to be "liberally construed... to exclude from change of ownership purchases or transfers between parents and their children described therein."[38] The Legislature stated its intent that

> Specifically, a transfer of real property from a corporation, partnership, trust, or other legal entity to an eligible transferor or transferors, where the latter are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property, shall be 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 of ownership provided by Section 63.1. Further, transfer 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.[39]

The Legislature's burial of its intent in an annotation was unfortunate. This muddle has created in certain counties problems for the practitioner attempting fully to utilize Section 63.1. The result of this camouflage has also been to create traps for the unwary when transferring real property among family members.

Penner v. County of Santa Barbara[40] demonstrates the disastrous effects of deviating from the literal terms of Section 63.1. In *Penner* the parent transferred the property to a partnership composed of the parent and children, then gifted more than 50% of the partnership interest to her children. The transfers "flunked" Section 63.1, resulting in a CIO for two reasons. First, the parent transferred *interests in legal entities* (partnership interests) rather than undivided interests in real property. Second, the parent transferred more than 50% interest in the property, again resulting in a CIO.[41]

The transferor in *Penner* should have transferred interests in real property to her children, followed by a joint transfer of the real property by both parent and children to the partnership. A necessary element would have required each transferor to hold the same ownership interest in the partnership as they held in the property prior to the transfer. Under those circumstances the transfers would not have resulted in a CIO, *even if* more than 50% of the real property had been transferred among parent and children

before transfer into the partnership. "Should" is used because, unfortunately, not all county assessors agree with the intention of Section 2 providing for liberality (precisely the case in *Penner*). Certain assessors will impose the "step-transaction" doctrine on the transaction to claim a CIO,[42] notwithstanding the contrary intent of the uncodified section.

If a decedent leaves Greenacre to her children A, B, and C equally Section 63.1 provides that the Parent-Child Exclusion will be available. In order to take advantage of the exclusion, however, the children must file the appropriate Assessor's Form. This form is the Claim for Exclusion from Re-Assessment by Reason of the Parent-Child relationship. No exclusion applies unless the form is timely filed, which must be the earlier of three years after the death of the decedent or before the sale of the real property.[43] Although not required by statute, certain counties, such as Alameda County, require a certified birth certificate of the transferee to be filed with the Claim for Exclusion from Re-Assessment.

What happens if the assessor gives a notice of supplemental assessment arising from the decedent's death and imposes a supplemental assessment? At this point a Claim for Refund may be made so long as time has not expired as set forth by statute.[44] Nevertheless, consistent with tax statutes in general, the taxpayer must pay the tax due as a condition of filing a Claim for Refund. In many counties it may be years before the Claim for Refund is heard. Accordingly, filing the Claim for Exclusion from Re-

assessment as soon as possible after the Change of Ownership has been filed with the Assessor is recommended in order to "fix" the right to the exclusion.

Now assume that the decedent leaves Greenacre equally to decedent's children A, B, and C, and that A transfers A's right to receive an interest in Greenacre to B before distribution of the estate. May B and C claim the exclusion from re-assessment for all of Greenacre? While the answer is not settled, it appears that the transfer of A's interest to B is a CIO, and one-third of Greenacre is appraised and re-assessed by the assessor. Under Probate Code section 7000 and 7001 title vests in the devisees (or heirs) on the decedent's death subject to administration. *California Academy of Sciences v. County of Fresno*[45] holds to the same effect.

Now assume that Greenacre is held in decedent's revocable trust, rather than being subject to a Will, and assume further that the trust does not restrict the Trustee from making non-prorata distributions.[46] In *LTA* dated January 23, 1991, the SBE advised that the power to make non-prorata distributions can reduce the amount of property qualifying for the parent-child exclusion. The facts used by this *LTA* are illustrative.

> A parent left a trust estate with a net worth of $500,000 to his four children in equal shares. The Trustee distributed Greenacre with a fair market value of $112,500 to Child 1. The Trustee distributed Blackacre with a fair market value of $225,000, but subject to a $50,000 encumbrance, to Child 2.

The SBE advised that Greenacre qualified for the parent-child exclusion, but only part of Blackacre qualified. The SBE advised that since the value of Greenacre was less than the portion of the

decedent's estate to which Child 1 was entitled ($125,000), the full cash value of Greenacre would qualify for the exclusion. In contrast, Child 2's receipt of Blackacre had the effect of Child 2 receiving 28.57% more property than what Child 2 was entitled to receive. This percentage was calculated by dividing the equity in Blackacre ($175,000) by the difference of the child's share of the total, divided by the equity ($175,000 - $125,000)) $175,000= 28.57%. Therefore, 28.57% of Blackacre was re-assessed.[47]

The SBE advised that if a Will gave the Trustee the express power to make non-prorata distributions the same result would occur.[48] The advice to the Assessor was through *LTA,* and therefore carried "considerable weight."

Now assume that the decedent leaves the decedent's personal residence to Child A, with the requirement that Child A pay Child B an amount of cash equal to the equity in the residence, so that A and B receive "equal" distributions. Relying upon *Woodley v. Woodley*[49] the SBE opined that the devise of the personal residence qualified for the parent-child exclusion because title was vested in Child A subject only to an "equitable charge" in favor of Child B. Child B was considered to be only an "equitable encumbrancer."[50]

A common estate plan includes transfers of real property through the Bypass, QTIP, and Survivor's Trusts. Upon the deceased spouse's death the Bypass and QTIP Trusts are funded, and assuming the trust is designed in a manner to qualify for the interspousal exclusion, the transfers are excluded from a CIO. Upon the surviving spouse's death, the typical plan results in either the

outright distribution of the property to the children, or continuing trusts in which the children have a present beneficial interest. Ordinarily, the transfer of real property from these trusts to the children, directly or indirectly, qualifies for the parent-child exclusion.

A problem for the practitioner is deciding *when* to allocate the exclusion. For example, assume that H and W own their personal residence, plus several parcels of commercial real property with full cash value of $1,800,000. Upon H's death,[51] H's Bypass Trust is allocated a parcel with a full cash value of $100,000, and the QTIP Trust is allocated a parcel with a full cash value of $800,000.[52] The Survivor's Trust is allocated a like amount of property. W dies several years later, at which time the full cash value of the property in the Bypass Trust is $110,000, in the QTIP Trust is $880,000, and in the Survivor's Trust is $990,000. Since W held a present interest in H's Bypass and QTIP Trust, H remained the transferor for purposes of the parent-child exclusion. Accordingly, the transfers from the Bypass and QTIP Trusts, amounting to $990,000 of full cash value, are within the $1,000,000 exclusion of Section 63.1 and qualify under H's available exclusion. Similarly, the transfers from the Survivor's Trust of W's property qualify under W's exclusion. Under Section 63.1 both H and W are *eligible transferors* and each has the $1,000,000 exclusion available, in addition to the personal residence.[53] The exclusion can only be claimed if H died after November 6, 1986 (the

effective date of Proposition 58), even if the *child's* present interest arises after November 6, 1986.[54]

If H gives W a power to withdraw annually the greater of $5,000 or 5% of the principal of the Bypass and QTIP Trust, as mentioned earlier, the 5 + 5 power is deemed to be exercised each year, regardless of whether it is actually exercised. In consequence, 5% of the full cash value of the Bypass and QTIP Trusts is treated as being transferred from H's "ownership" to W's "ownership" each year. The total amount of property deemed to have been transferred, therefore, might be substantial, especially if W outlives H for many years. Under these circumstances, it is entirely plausible that at W's death W will be deemed to own real property with full cash value greater than $1,000,000.[55] This unforeseen result can wreak havoc on a family's ability to shield property from re-assessment.

A perplexing problem arising from the survivor's "deemed" use of the 5 + 5 power is determining which parcels have been transferred. No actual transfer from the Bypass Trust or the QTIP Trust occurs. Therefore it is extraordinarily difficult to decide which property remaining in those trusts at the survivor's death is eligible for the deceased spouse's exclusion, and which are not. The converse is true for the surviving spouse's $1,000,000 exemption. How does one complete the Parent-Child Exclusion forms for *each* transferor? Filing two Parent-Child Exclusion Forms, cross-referencing the other, may be the most practical choice because Section 63.1 does not contemplate a joint exclusion.

Practitioners also should not overlook the consequences of purchase and sales, or exchanges, on the availability of the exclusion. If the Bypass Trust buys Greenacre after H's death, but before W's death, the children will not be able to claim the exclusion as to H. In this case H never owned Greenacre, and therefore H is not the *original* transferor. Accordingly, upon W's death, there will be a CIO.

Similarly, if the QTIP Trust exchanges Greenacre for Blackacre in a tax-deferred exchange under Internal Revenue Code section 1031, the immediate effect is a CIO, and re-appraisal, when the QTIP Trust completes the exchange. When W dies, there will be another CIO and re-appraisal because H did not own Blackacre at the time of his death and again is not an *original* transferor.

Parent-Grandchild Transfers

The parent-child exclusion fails to provide for the surviving issue of a predeceased child, an oversight the voters corrected in the 1996 March election. Effective March 27, 1996, "orphaned" grandchildren are able to receive the same treatment as children of a transferor under Article XIII A, Section (h), sub-division (2) of the California Constitution. This proposition was codified prior to the end of the 1996 Legislative session.[56]

Section (h), sub-division (2), paragraph (A) provides that where *both* parents (child of the transferor and the child's spouse) of the grandchildren of the transferor are deceased, the grandchild may participate to the same extent as a child in sharing the grandparent transferor's parent-child exclusion for real property

with an aggregate full cash value of $1,000,000. The provision, however, limits a grandchild to receiving one principal residence. If the grandchildren receive a second principal residence, the full cash value of the residence that "fails to qualify" for the exclusion, and the full cash value of the other real property transferred by the grandparent-transferor, are included within the $1,000,000 exclusion. This provision is hard to follow, but may be illustrated by the following example.

The parents, C1 and C1S, of grandchildren GC1 and GC2, are deceased. After March 27, 1996, C1's father dies and leaves his principal residence to GC1 and GC2. The appropriate parent-grandchild exclusion form is filed and the principal residence passing to GC1 and GC2 is excluded.

After March 27, 1996, C1S's mother dies leaving a principal residence with a full cash value of $400,000 and other real property with an aggregate full cash value of $900,000. C1S's mother makes equal distributions of her estate to her children, C1S, C2, C3 and C4, with the surviving issue of any deceased child taking by right of representation. Therefore, the beneficiaries and their percentage of the estate of C1S's mother are as follows: C2 (3), C3 (3), C4 (3), GC1 (χ) and GC2 (χ).

> The parent-child and parent-grandchild exclusion allow all of the $900,000 of full cash value of the other real property to be excluded from a CIO. As to the principal residence of C1S's mother, however, 3 will not qualify because GC1 and GC2 have already received a

principal residence. Therefore, one-quarter of the full cash value of the principal residence does not fall within the principal residence exclusion, but must be aggregated with the other real property.

In this case, 3 x $400,000 of full cash value of the principal residence results in $100,000 being added onto the $900,000 of other real property, resulting in the full $1,000,000 being utilized to exclude the one-quarter of the principal residence passing to GC1 and GC2 from a CIO.

Must both children (parents of the grandchildren) be dead in order for the parent-grandchildren exclusion to apply? This issue was anticipated by the drafters of the proposition. The purchase or sale between grandparents and grandchildren will be excluded if the transfer "otherwise qualifies under paragraph (1), if all the parents of that grandchild or grandchildren, who qualify as the children of the grandparents, are deceased as of the date of the purchase or transfer."[57] In interpreting the parent child exclusion, the statute provides that the parent-child relationship with a son-in-law or daughter-in-law "shall be deemed to exist until the marriage on which the relationship is based is terminated by divorce, or if the relationship is terminated by death, until the remarriage of the surviving son-in-law or daughter-in-law."[58] Accordingly, where the grandchild has a surviving parent, but the parent has ceased to be a "child" of the grandparent-transferor within Section 63.1, the parent-grandchild exclusion applies. A

legal separation between the grandchild's parents will vitiate any potential parent-grandchild exclusion if the daughter-in-law or son-in-law of the grandparent-transferor is living.

Combining Exclusions

As discussed earlier, if the trust instrument provides for income to be distributed to the surviving spouse and to issue of the spouses by the Trustee pursuant to a discretionary "sprinkling" power the surviving spouse is no longer the sole beneficiary. The surviving spouse no longer has a *beneficial interest* which is *substantially equal* to the value of the fee interest,[59] and therefore a CIO has occurred.

If the parties subject to the discretionary power are the surviving spouse and the spouse's children, may both the interspousal and parent-child[60] exclusions be claimed? If both exclusions are available, how are they to be allocated? In short, how much of the present interest should be allocated to the surviving spouse, and how much should be allocated to the children.

This inquiry is not merely theoretical. The problem presents itself when completing the Assessor's form. This forms generally entitled Change in Ownership - Death of Real Property Owner,[61] the PCOR, and the Request of Exclusion for Re-Assessment for Transfers Between Parent and Child do not contemplate a an allocation of multiple exclusions. These interests are not quantified in the trust instrument, and therefore it may be unreasonable to expect the Assessor to create a form that would quantify them. Arguably, the inability to quantify the respective interests that qualify for

an exclusion results in the entire property suffering a CIO.

The authors do not like the conclusion that the inability to quantify results in a CIO, but are not able to provide any basis for a contrary conclusion. Inasmuch as no authority or guidance exists the result is a minefield waiting to explode.

JOINT TENANCY TRANSFERS

The rules applicable to joint tenancy transfers are arcane. Section 65(a) defines a change in ownership of a joint tenancy interest as the "interest or portion which is transferred from one owner to another owner".[62] A newly created joint tenancy (i.e. C conveys to A and B, as joint tenant) results in the joint tenants being *original* transferees to the transferor.[63]

Section 65(b) states there is no change in ownership "upon the creation or transfer of a joint tenancy interest if the transferor or transferors, *after* such creation or transfer, are among the joint tenants.[64] Section 65(d) states that upon termination of a joint tenancy interest held by any joint tenant *other than* the original transferor, there is no reappraisal under subdivision (b), if the entire joint tenancy interest is transferred either to an *original* transferor or to all remaining joint tenants so long as one of the remaining ones is an *original* transferor.[65]

Transfers between spouses qualify for the interspousal exclusion of Section 63. Accordingly, if the spouse of an *original* joint tenant is added as a joint tenant after the acquisition, the spouse becomes an *original* joint tenant or transferor.[66]

The "Rule of Convenience" under Revenue & Taxation Code section 65, subdivision (e), permits a rebuttable presumption that all owners vested in title as joint tenants on March 1, 1975, are *original* joint tenants or transferor. These rules are most easily explained by examples. Assume that A and B, unrelated parties, buy Greenacre and are vested in title as joint tenants. B's spouse is subsequently added as a joint tenant. B's spouse is an *original* transferor for purposes of creation or transfer of joint tenancy interests. Additionally, under Section 65(a), A, B, and B's spouse are *original transferees*, having (or being deemed to have) taken title together from a common source.

Now assume that A and B, unrelated parties, buy Greenacre and are vested in title as joint tenants. After becoming vested, they add C, an unrelated party, as a joint tenant. There is no CIO because A and B remain vested as joint tenants.[67]

Now assume that after becoming a joint tenant, C sells his interest in Greenacre to D. There is a transfer of C's interest and a CIO of C's interest *only*. The transfer by C to D is a partition or severance of the joint tenancy, and therefore, is a CIO of that tenancy in common interest. If C was deleted from title and D added as a joint tenant, there would not have been a CIO because A & B would have remained vested as joint tenants. Similarly, if A sold A's interest to C, there would be a CIO of A's interest, 50%, because there would have been a severance of the joint tenancy.

Now assume that A and B, unrelated parties, acquire Greenacre as joint tenants. Subsequent to acquiring Greenacre, B's spouse, S, is added as a joint tenant. A, B, and S, add C and D, unrelated parties, as joint tenants. Under the rules described above there is no CIO.

Using the same example, assume that C transfers C's interest to D. There is now a transfer to someone who was not an *original* transferor, and a CIO as to a 20% interest because of the 5 owners. The same result occurs for the same reasons if C transfers C's interest to a new party, T.

Assume that instead of transferring C's interest to D, C transfers C's interest to A. Because this transfer is to an *original* transferor it would be excluded. If C transfers C's interest to A, B, or S, *or* "to all remaining joint tenants" there is no CIO because the interest passes to an *original* transferor.

If A transfers A's interest to B, however, there *is* a CIO because A owned one-half of the *original* joint tenancy and was only an *original transferee* with B under Section 65(a). The original transferor is not allowed the option of transferring inter vivos to either another original transferor or to all remaining joint tenants without incurring a CIO.

No assume that A dies. B and B's spouse succeed to A's interest as surviving joint tenants. Because an original *transferee* died, there is a CIO under Section 65(a). As between a and B, B is not an original *transferor*.[68] The exclusion only

applies when the interest of an *original* transferor passes at death by "operation of law."[69]

If B transfers B's interest to B's spouse S no CIO occurs because of the interspousal exclusion under Section 63. If S transfers S's interest to anyone else, however, including an *original* transferor, such as A, a CIO will result because S is not an original transferor.

If A, B, and S transfer their interest to C and D as joint tenants a complete turnover of the *original* transferors has occurred and there is a CIO as to 100% of Greenacre. After re-appraisal and re-assessment, C and D are now *original* transferors.

Now assume that A bought Greenacre in 1952, and added B, her nephew, as a joint tenant in 1956. A dies after March 1, 1975. If the "Rule of Convenience" applies, then A and B were joint tenants on March 1, 1975, and there is no CIO because the interest passes to B, an *original* joint tenant by operation of law. If the Assessor chooses to ignore the "Rule of Convenience" by relying on the recorded deeds, there will be a CIO because the "Rule of Convenience" will be rebutted.

If A had instead gifted her interest to B during her life, but after March 1, 1975, there would have been a CIO as to the entire property. A was the *original* transferor of the entire property at the time of acquisition of Greenacre.

As the foregoing examples demonstrate, the planner should never assume or predict there will be no CIO in a joint tenancy without knowing all of the facts and considering the result. The

assessor knows because the assessor has access to all of the deeds and can determine the result. If the practitioner records deeds without having the same information, the practitioner may end up with egg on the chin.

Entities - To and From

Nearly all of the case law generated from Article XIII A concerns changes of ownership in entities owning real property. Disputes have arisen resulting from the transfer of real property upon the formation of the entity, upon the transfer of ownership interests among the entity's owners; and upon the transfer of real property from the entity to the owners. Generally, the underlying facts of the case law involves corporate restructuring through acquisition, merger, and parent-subsidiary changes. As a result, many of the issues addressed by the cases are beyond the ordinary scope of estate planners and practitioners assisting in a probate or trust administration.

In recent years, however, estate planners have increasingly focused on the estate and gift tax benefits of using entities by which the older generation can pass its interest in property to the younger generation. The much discussed theory is that ownership of an interest in an entity owning property is worth less than direct ownership of the property. An additional perceived benefit is that when the ownership is divided, the value of the retained interest is diminished. The proponents of this technique also argue that value can be reduced because dividing ownership makes the property less marketable. Current "cutting edge" estate planning involves

using S Corporations, limited partnerships, and limited liability companies to take advantage of these factors in order to reduce the fair market value (and therefore the estate taxes) of the underlying property.

An often overlooked aspect of these techniques, however, is the effect on real property taxes. These entities are subject to Article XIIIA, so it is important to understand how to transfer property to, and distribute property from, these entities without triggering a CIO. While the rules appear to be straight-forward, transfers of interests within entities can create unexpected results.

Section 64(a) states the general rule:

> Except as otherwise provided in subdivision (h) of Section 61 and subdivisions (c) and (d) of this section, the purchase or transfer of ownership interests in legal entities . . . . shall not be deemed to constitute a transfer of the real property of the legal entity . . . .[70]

Section 62(a)(2) excludes from the definition of change in ownership

> Any transfer between an individual or individuals and a legal entity or between legal entities . . . which results solely in a change in the method of holding title to the real property and in which the proportional ownership interests of the transferor and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer. . . ."[71]

The intention of Section 62(a)(2) is to allow the transfer of real property upon formation of an entity without a CIO so long as the "proportional ownership interests" remain unchanged before and

after the transfer. For example, if Husband, Wife, and Child own 40%, 40%, and 20% undivided interests, respectively, in real property, then creation of an entity where the ownership interests are held by Husband, Wife and Child in exactly the same percentages will not be a change of ownership under Section 62(a)(2). Additionally, if Husband and Wife subsequently transfer 10% of their respective ownership interests to Child, there will be no change of ownership under Section 64(a).

Now assume, however, that Husband, Wife and Child own different percentages of Greenacre (40%, 40%, and 20%) and Blackacre (35%, 35%, and 30%). A transfer of Greenacre and Blackacre to an entity that Husband, Wife and Child own 35%, 35% and 30%, respectively, *will* be a change in ownership for Greenacre. The "proportional ownership interest" held by Husband, Wife and Child in Greenacre is changed after the transfer of Greenacre to the corporation. Additionally, the CIO will be as to the entire property, because there is no applicable exclusion other than Section 62(a)(2).[72]

Section 64(c) & (d) excludes any transfer of interests in an entity if the entity was formed through a transaction excluded from a change of ownership under Section 62(a)(2).[73] Section 64(c) applies an exception to transfers of interests in *any* legal entity whenever or however created. Accordingly, for an entity created before March 15, 1975, only subdivision (c) applies.

Section 64(c) states that a CIO occurs when any person, whether an individual or a "legal entity," gains control of more

than 50% of the ownership interests. The section includes "any purchase or transfer of 50 percent *or less* of the ownership interest through which control or a majority ownership interest is obtained."[74] In gaining "control" it does not matter whether the individual or legal entity acquires 50.1% or 0.1%: a CIO has occurred.[75] An explicit exception to subdivision (c) applies when an owner of a majority interest in any partnership acquires the remaining partnership interests after January 1, 1996.[76]

Section 64(d) provides that a CIO occurs when more than 50% of the total interests of the entity are transferred by the original co-owners in one or more transactions.[77] The difference between subdivisions (c) and (d) is illustrated by the following example:

Assume that Doe owns 100% of Corporation, which acquires AA, BB, and CC real properties on January 1, 1971. On June 1, 1976, Doe transfers real property DD to Corporation. On October 1, 1982, Doe sells 60% of Doe's shares in Corporation to Sam, Sally and Seth in equal amounts of 20%.

Section 64(c) permits no change of ownership as to AA, BB, and CC because no one owns more than 50% of the shares of Corporation. Doe owns 40% and Sam, Sally, and Seth each own 20%. Under 64(d) there is a change of ownership as to property DD because more than 50% of the interest in Corporation X was transferred.[78] Section 64(c) applies to AA, BB, and CC because the transactions transferring them to the corporation occurred before March 1, 1975, without use of 62(a)(2).

Although not an explicit exception to Section 64, the application of the "step transaction" doctrine enables the creative (or "concocted", depending on your viewpoint) use of the applicable sections to avoid a CIO by having each transaction in a series qualify for an exclusion. At the end of the series is a taxpayer that, when compared with the entity in the beginning, is a different taxpayer under Article XIIIA. If the series of transfers were compressed into one transaction, the result would be a CIO. Under the "step transaction" or "substance over form" doctrine, the intermediate steps are disregarded, and a CIO is deemed to have occurred, notwithstanding all of the intermediate steps. *Shuwa Investments Corp. v. County of Los Angeles*[79], the seminal case applying the "step transaction" doctrine, takes the "gamesmanship" out of the CIO rules.

The only exclusion to the "step transaction" doctrine is for parent-child transfers. As discussed earlier, the expressed Legislative intent creates an explicit exception for parent-child transactions which would otherwise be "step transactions".[80] The following example illustrates the effect of the legislative intent:

Assume that Husband owns Corporation as his separate property and Corporation owns Greenacre. Husband dissolves Corporation and it conveys Greenacre to Husband. Husband then conveys Greenacre to Husband and Wife as community property. Husband and Wife then convey Greenacre to a general partnership in which Husband and Wife are the sole general partners. Husband and Wife then give 48% of

the total general partnership interest to each of their three children, in equal shares.

Under the "step transaction" doctrine all of the transactions would be compressed. Husband would be deemed to have conveyed his sole ownership interest in Greenacre to an entity owned by him, his spouse, and his children, and there would be a CIO. Nevertheless, this transaction is precisely the type that the Legislature explicitly excepts from the "step transaction" doctrine.[81]

The legislative intent is not without limits, however, and can not be used in order to avoid the CIO rules to effect a result inconsistent with Article XIIIA.[82] The lesson of *Penner*[83] is that in order to obtain the benefit of the parent-child exclusion one must go through the intermediate steps. To phrase it more bluntly: Form Over Substance matters when seeking to claim this exclusion.

In *Penner* the taxpayer transferred real property directly from herself to a limited partnership owned by herself and her two children. The transaction did not qualify for the exclusion under Section 62(a)(2). To qualify for the exclusion, the taxpayer should have transferred undivided interests in the property to her children *before* transfer to the partnership in which she and her children owned the same proportionate interests before and after the transfer.[84] *Penner* is the first published case recognizing the legislative intent found in uncodified Section 2 of the statute,[85] and provides practitioners with an exemplary example of how *not* to transfer property from the older generation to the younger generation by use of entities. Albeit *dictum*, the reference is

Penner to Section 2 will be useful in those counties where the assessors are ignorant of the section, or prefer to ignore its existence as a legislative exception to the "step transaction" doctrine.

Section 2 creates considerable opportunity for estate planners when establishing the entities our clients desire to use to save estate taxes. The proportionate ownership interest exclusion of Section 62(a)(2) remains available even if the character of the ownership interest is changed upon the transfer. For example, assume that A and B own Whiteacre equally as tenants in common. A and B transfer their respective interests in Whiteacre to WAB, a California limited partnership. A receives a 50% general partnership interest and B receives a 50% limited partnership interest. No CIO occurs because the proportionate interests remain the same, even though the ownership relationship between A and B has changed.

In demonstrating the flexibility of Sections 62(a)(2) and 64 the following, progressive example is useful. Assume that Parent (P) owns 100% of Greenacre, a property with full cash value of $500,000, but with a fair market value of $1,000,000. P transfers to each of her three children (C1, C2, and C3) a one-quarter (3) undivided interest in Greenacre. P, C1, C2 and C3 then form Corporation, owned equally. P, C1, C2, and C3 each then transfer a .25% undivided interest (1% total) in Greenacre to Corporation. Corporation, P, C1, C2, and C3 then form a limited partnership (FLP), of which Corporation is the 1% general partner, and P, C1,

C2 and C3 are each 24.75% limited partners. Corporation, P, C1, C2 and C3 then transfer Greenacre to FLP.

If the "step transaction" doctrine applied, all of these transactions would be compressed into a transfer by P to a limited partnership in which P owns only a 24.75% limited partnership interest, so that the requirement of the same proportionate ownership by owners before and after the transfer would not be satisfied. Because uncodified Section 2 of Section 63.1 does apply, however, the transactions are viewed differently.

First, the transfer by P to her children of undivided interests in Greenacre falls within the parent-child exclusion of Section 63.1. Assuming P has not already transferred property to her children of more than $625,000, the transfer of : of Greenacre, with a full cash value of $375,000 (: x $500,000) is within her $1,000,000 exemption. Of course, in order to claim the exclusion, P must file a Parent-Child Exclusion Form with the county assessor, and list the transfer and the amount she is applying to this transfer.

Second, the transfer by P, C1, C2 and C3 of an aggregate 1% interest in Greenacre to Corporation is not a CIO because the transfer is within Section 62(a)(2). The same owners own the same proportionate ownership in Greenacre and in Corporation before and after the transfer. Third, the transfer of Greenacre by Corporation, P, C1, C2 and C3 to FLP is excluded from a CIO because of Section 62(a)(2) as well.

The prior example concerned creating the entity. What about gifting within the entity after formation? This technique is often suggested to clients by estate planners as a continuation of the formation process, still for purposes of minimizing estate taxes.

Assume the facts of the prior example. Now assume further that P gifts her 24.75% limited partnership interest in FLP equally to C1, C2 and C3. The result is that C1, C2 and C3 each own 33% limited partnership interests in FLP while Corporation continues to own a 1% general partnership interest.

Under Section 64 there is no CIO. First, section 64(a) provides that transfers of interests in entities are not considered transfers of real property unless an exception applies. Second, Section 64(c) provides that when no partner has obtained more than 50% of the ownership interests of FLP, no CIO has occurred. Third, under Section 64(d) less than 50% of the partnership interests in FLP has been transferred (only 24.75%), and therefore no CIO has occurred.

Assume all of the prior facts, but P and C1 die in a car accident. Under P's estate plan, P's interest passes in equal shares to C2, C3, and the surviving child of C1 (GC1). Under C1's estate plan, GC1 receives all of C1's interest in FLP and Corporation.

P's death alone does not create a CIO. P's only interest is the 25% ownership interest in Corporation, and Section 64(a) requires transfer of more than 50% interest in Corporation for Greenacre to suffer a CIO.

C1's death, however, would probably cause a CIO because C1 owned a 33% interest in FLP and a 25% interest in Corporation. If the 33% interest is added to the 24.75% interest previously transferred by P, the limited partnership interest transferred exceeds 50%, and Section 64(d) would cause recognition of a CIO. 8.25% of C1's limited partnership interest, however, derived from P's gift.

Should the same 8.25% limited partnership interest be counted twice? Unfortunately, Section 64(d) does not answer this question.

The transfer of the limited partnership interest from C1 to GC1 counts as part of the 50% because the parent-child exclusion applies to transfers of real property or interests in real property only. The transfer from C1 to GC1 of the FLP interest does not satisfy the requirements of the exclusion. The 25% interest in Corporation transferred from C1 to GC1 would not cause a CIO, with respect to Corp's limited partnership interest in FLP, however, because more than 50% interest had not been transferred.

Strict adherence to the technical requirements may create a series of transactions that would nominally comply with the statutes, but which would nevertheless be treated as a CIO. For example, assume that H and W own Greenacre. Greenacre has a full cash value of $3,900,000 and a fair market value of $8,000,000. H and W transfer a 17% undivided interest in Greenacre to each of their three children (C1, C2 and C3), for a total of 51%. The result is that H and W each own a 24.5% undivided interest, and C1, C2, and C3 each own a 17% undivided interest in Greenacre. H, W,

C1, C2, and C3 then contribute their respective undivided interests to a limited liability company (FLLC) in which each maintains the same proportionate ownership interest in Greenacre.

Assuming a Claim for Exclusion is filed, the transfer by H and W to C1, C2 and C3 qualifies for the parent-child exclusion under Section 63.1. H and W each use $955,500 of their respective $1,000,000 exemptions (.245 x $3,900,000 = $955,500). In this manner, H & W are able to transfer about 64% of the total assessed value of Greenacre ($955,000 x 2 = $1,910,000) and avoid a CIO.

Now assume that one year later H and W gift the remainder of their membership interests in FLLC to their children, with the result that C1, C2, and C3 each own one-third of FLLC. Greenacre now has a fair market value of $8,000,000 and a full cash value of $3,978,000. No CIO has occurred because section 64(c) requires a transfer of more than 50%, and section 64(d) holds that the majority of the membership interests in FLLC have not been transferred. It appears that H and W have very effectively transferred Greenacre, with assessed value in excess of $3,900,000 and a fair market value of $8,000,000, without any increase in property taxes.[86]

Despite this adherence to the technical rules of Section 64, the authors believe that this series of transactions will lead to a CIO. The last sentence of the uncodified Section 2 states that

> 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.[87]

Notwithstanding an assertion of "business purpose", the facts of Example 3 show the intent to transfer more than the $1,000,000 of cash value per transferor permitted under Section 63.1. The authors doubt that the SBE, the Assessor, or a Court will view the transaction as anything but an attempt to transfer more than what is allowed.

Even though H and W were not content to remain pigs, and became hogs that went to market, the authors believe that the aggregate 51% interest (the portion of Greenacre transferred to C1, C2 and C3 under Section 63.1) should not suffer a CIO. Moreover, the transfer of the 49% membership interests in FLLC by H and W did not trigger any CIO within Section 64(c) or (d). Accordingly, it *would seem* the CIO should be limited to 49% of Greenacre. Unfortunately, little guidance exists, particularly with fact patterns which cut across different sections and exclusions of the Revenue and Taxation Code.

Now assume that H & W give away their interest in FLLC over a period of years, rather than all at once. The challenge becomes *when* the CIO occurs. After two years of gifting 1% interests, and assuming that the full cash value of Greenacre increases by 2% annually, H and W have given away more than $1,000,000 of full cash value each.[88] With no certain answers available, it *would seem* the CIO occurs with the gifts in Year 2 when H and W have transferred more than the $1,000,000 of full cash value of Greenacre occurs because at this point the exception of uncodified Section 2 no longer applies. If the CIO occurs in Year 2, it is unclear whether

all or part of Greenacre be subject to a CIO, because all of H's and W's membership interests have not yet been transferred (they still own, cumulatively, 47% of the membership interests). What is clear is the lack of a definitive answer at this intersection of Sections 63.1 and 64. As one extends the facts of the example, the inconsistencies between Section 63.1, Section 64, and the Step Transaction Doctrine become more evident. For instance, assume in the last example that H and W make no further gifts to C1, C2 and C3, and that twenty years after FLLC was formed H and W die simultaneously. Should the Step Transaction Doctrine apply to cause a CIO because more than $2,000,000 of full cash value was transferred? If the Step Transaction Doctrine does not apply, then what are the criteria that distinguish this example from the previous ones?

As a final contrast, consider the fact that H and W may transfer their remaining 49% interest in FLLC to anybody besides their children, including to their grandchildren, without triggering a CIO because less than 50% of the ownership interests in FLLC will have been transferred (assuming C1, C2 and C3 retain their interests). No sound policy reason exists to avoid a CIO in these circumstances, while a transfer to C1, C2 and C3 of H's and W's remaining interest may trigger a CIO by application of the Step Transaction Doctrine. Plainly, these are uncommon examples, but they do demonstrate the ambiguities within the Article XIII A framework.

When a CIO occurs within in an entity, the entity is required to file a change in ownership statement with the SBE.[89] If the CIO is not reported, when it is discovered, the result will be a re-appraisal of the property and levying of escape or supplemental assessments for all tax years from the CIO to the present, together with penalties in appropriate cases.[90]

CONCLUSION

As the authors hope to have highlighted, the superficially simple rules of Proposition 13 contain a plethora of traps for the unwary, as well as inconsistent application by the supervising administrative agencies. An ounce of prevention is worth a pound of cure, which in property taxation suggests that clear communication with the Assessor is important. The authors recommend that practitioners complete the *Preliminary Change of Ownership Report* and *Claim for Reassessment Exclusion* as thoroughly as possible in order to forestall the assessor=s claim of a change in ownership.

1. Frayda L. Bruton, *California Property Tax: Clearing a Path Through the Legislative Thicket*, 2 California Trusts & Estates Quarterly No. 3, p.42 (Fall, 1996) (hereafter *Bruton*).

2. California Constitution, Article XIIIA, Section 2(b); Revenue & Taxation Code section 51.

3. California Constitution, Article XIIIA, Section 2.

4. Revenue & Taxation Code section 110.

5. *See* City & County of San Francisco v. County of San Mateo, (1995) 10 Cal.4th 554, 566; 41 Cal.Rptr. 2d 888.

6. Revenue and Taxation Code section 60.

7. *Bruton*, p.42

8. *Bruton,* p. 42, 44.

9. Government Code section 15606(e).

10. "While it has been said that the contemporaneous construction given to a statute by administrative officials charged with its enforcement and interpretation is entitled to considerable weight, it is well settled that such interpretation should be followed only if it is not erroneous (citation omitted]); and that the final responsibility for the interpretation of the law rests with the courts, not with the administrative agencies (cite omitted])" Dreyer's Grand Ice Cream, Inc. v. County of Alameda (1986) 178 CA3d 1174, 1183; 224 Cal.Rptr. 285.

11. Revenue and Taxation Code section 480, subdivision (b).

12. Revenue and Taxation Code Section 63

13. Revenue and Taxation Code section 63 (a); *Bruton*, p.43-44

14. Revenue and Taxation Code sections 63(b) and (e), concerning transfers to effect a property settlement agreement which permit spouses dissolving the marriage to transfer property between them (before or after the actual dissolution) without causing a CIO and corresponding re-assessment.

15. Revenue and Taxation Code section 60.

16. *See* Family Code section 761 concerning revocation of trusts containing community

property.

17. Revenue and Taxation Code section 60.

18. Internal Revenue Code Section 2056(b)(7)(B).

19. Revenue & Taxation Code э 63(a).

20. Treas. Reg. э20.2056(b)-5(b)(f); *See* PLR8948002, PLR 8931005.

21. See *Estate of Canfield* (1947) 80 CA2d 443, 451; *Estate of Johnson* (1961) 198 CA2d 503, 510. See discussion in Correspondencedated June 16, 1995, and Correspondencedated December 14, 1993, citing Correspondencedated August 31, 1981. Under the Correspondencedated June 16, 1995, the other persons possess only an *equitable remainder interest* - a future interest; the Correspondencecites Civil Code section 769. Under the cited cases above, the Correspondencecontinues to state that, therefore, the other person's interest in a principal distribution is only a "mere expectancy". The Correspondencethen analogizes the "mere expectancy" to tax law wherein the interest of the other persons's is deemed a *future* interest as opposed to a present interest for federal gift tax purposes because the exercise of discretion by the Trustee is a barrier to the other persons' present enjoyment of the trust principal. The Correspondencecites *Jactobson v. U.S.* (1973) 42AFTR2d 78-6499.

22. See Endnote 15. above.

23. *Bruton*, p 43-44

24. Article XIIIA, Section 2(g).

25. Article XIIIA, Section 2(g)

26. *Larson v. Duca* (1989) 213 CA3d 324, 329, where the Court stated "[i]n interpreting constitutional measures enacted by the voters, we must also follow the rule that .... 'The adopting body is presumed to be aware of existing laws and judicial construction thereof.' [citation]"

27. See *Corr* dated September 12, 1994.

28. *Id.*

29. Revenue and Taxation Code Section 64, subdivision (d). See the *Entities* section of this article following.

30. Internal Revenue Code Section 2041(b)(2). See IRC Regulation 20.2041-3(d)(3), (4), and (5).

31. See *Corr* dated April 6, 1992.

32. Section 63.1(c)(3).

33. Section 63.1 (a).

34. R&T section 63.1 (c)(4). *See* R&T section 63.1(c)(5) where "eligible transferee" is defined as "a parent or child of an eligible transferor". See also R&T section 63.1(c)(2)(B) where "children" is defined so as to include stepchildren and spouses and section 63.1(c)(2)(C) where spouses of children are included.

35. *Ibid*.

36. Section 63.1. subdivision (c)(7).

37. Section 63.1, subdivision (c)(6).

38. Stats 1987 ch 48, Section 2. This section may be found in the annotations to Section 63.1.

39. *Ibid*.

40. (1995) 37 CA4th 1672, 44CR2d 606.

41. Section 64(d) - see Legal Entities Section later. Along the way, however, the transferor in Penner failed to qualify the transfer for the exclusion under Section 62(a)(2) which excludes transfers between an individual and legal entities where the proportional ownership interests before and after the transfer remain the same so that there is only a change in form. In Penner there was only 1 transferor - a transfer to a partnership, therefore, inevitably caused a CIO because the other partners would have an interest they wouldn't have had before the transfer.

42. *See* discussion on step-transaction below.

43. Similar to all statutes of limitation, when to file is not simple. For transfers before September 30, 1990, the claim must be filed within 3 years of the date of transfer. Since a decedent's interest passes upon his or her death, the transfer, subject to administration of the decedent's estate, passes as of the date of death. See Probate Code section 7000 and 7001 and California Academy of Science v. County of Fresno (1987) 192 CA3d 1436; see Section 63.1(e)(1). For transfers occurring after September 30, 1990, within three years after the date of transfer or transfer to a third property, whichever is earlier; see Section 63.1(e)(2). But a claim is timely filed *if* it is filed within six months after the date of mailing of a notice of a supplemental or escape assessment, issued as a result of the purchase or transfer of real property for which the claim is filed.

44. *Ibid*.

45. *Ibid*.

46. One of the powers vested in a Trustee under California law is the power to make non-pro-rata distributions. See Probate Code section 16246.

47. See *LTA* dated January 23, 1991. The SBE advised re-appraisal would be as follows:

1975 Factored base year value - $75,000 x 71.43% =	$ 53,572
1990 Fair Market Value - $225,000 x 28.57% =	64,282
Re-assessed value	$117,854

48. *Ibid*.

49. (1941) 47 CA2d 188.

50. *Correspondence* dated February 14, 1995.

51. Do the authors need further continuing education in bias because of their assumptions husband will die first?

52. Remember, "full cash value" is what the property is not assessed at. The property may have a *fair market value* of considerably more.

53. See *Correspondence* dated June 19, 1987, and *Correspondence* dated April 6, 1992.

54. Notwithstanding that one of the authors received such advice in correspondence from the SBE, R&T э63.1(h) explicitly forbids claiming the exclusion for a decedent dying prior to November 6, 1986.

55. See *Correspondence* dated April 6, 1992. In an example where W survives H by 17 years, this *Correspondence* states that 85% of H's full cash value is transferred to W; 17 years x 5% per year. This does not appear a correct result because, after exercise each year, the 5% of the full cash value changes in value (i.e. there's less to take 5% of). Moreover, each year the full cash value increases by 2%. Therefore, in determining the effect of the 5 + 5 power, one must look at the amount transferred each year and aggregate them.

56. Amendments to R&T э63.1.

57. California Constitution, Article XIII A, Section (h), sub-division (2), paragraph (A).

58. Revenue and Taxation Code section 63.1, sub-division (c), paragraph (2), sub-paragraph

(c) defining "children". Sub-paragraph (B) provides for the spouse of a step-child in the same way as paragraph (c) provides for a daughter-in-law or son-in-law.

59. Revenue and Taxation Code section 60.

60. Revenue and Taxation Code Section 63.1: exclusion from CIO for transfers between parent and children. See the following section of this Article.

61. Revenue and Taxation Code Section 480, subdivision (b).

62. Revenue and Taxation Code Section 65, subdivision (a).

63. See *Corr* dated June 29, 1992, for explanation. A transfer to A, B, and C results in A, B, and C being original transferees to themselves. As seen by rule 2 following, under Revenue and Taxation Code section 65, subdivision (b) A, B, and C are *original transferors* as to future transferees who are added as joint tenants or conveyed interests by A, B, or C.

64. Revenue and Taxation Code section 65, subdivision (b).

65. Revenue and Taxation Code section 65, subdivision (d).

66. See SBE Correspondence dated April 15, 1987, referenced at 220.0185, at page 4, citing the legislative history of the joint tenancy exceptions.

67. See Section 65(d).

68. See *Corr* dated July 10, 1991. Therein, a mother and son obtained property from the mother's parents as joint tenants in August, 1972. In 1982 the mother died and the succeeded as the surviving joint tenant. This is a change in ownership as to 50% for the reasons stated. Under Section 65(e) the Assessor could have applied the Rule of Convenience, but elected not to do so, being able to go back and show that in 1972 both mother and son were transferees.

69. *Ibid*, page 6.

70. Revenue and Taxation Code section 64(a)

71. Revenue and Taxation Code section 62(a)(2).

72. The exceptions to 64(a) involve transfer of stock in a cooperative housing corporation and the exceptions contained in Section 64, subdivisions (c) and (d).

73. The section cites March 1, 1975, as the effective date, which is the "beginning" of the Article XIII A era.

74. Section 64(c).

75. See Revenue and Taxation Code section 64(c)(1), Italics are added to emphasize the point that a transfer of less than 50% will result in a CIO if the acquiring party has control or a majority interest. The following is an interesting question: Is there a difference between "control" or a "majority interest"? Although the authors have seen no case or correspondence on the issue, it would seem there is a difference. For instance, "control" of a corporation may be obtained through one person acquiring voting proxies from other minority owners so that , cumulatively, the one person has voting control of more than 51% interest.

76. Revenue & Taxation Code section 64(c)(2). The Legislature created the exception after Zapara v. County of Orange (1994) 26 CA4th, 31 CR2d 555, where a CIO was found after the majority shareholder acquired all of the other partnership interests. Logically, subdivision (c)(2) should apply to limited liability companies (where you also need 2 to have one) as well; but subdivision (c)(2) is limited solely to partnerships.

77. Revenue and Taxation Code section 64(d).

78. See *LTA* dated February 18, 1983. If the example is varied so that S1, S2, and S3 formed a partnership P and partnership P purchased 60% of the outstanding stock in Corporation X, then there would be a CIO because the entity, partnership P, acquired majority interest.

79. (1991) 1 CA4th 1635

80. See section concerning Parent-Child Exclusions above.

81. Section 2 of Chapter 48 of the Statutes of 1987.

82. *See e.g. Penner v. County of Santa Barbara, **supra**.*

83. *Penner v. County of Santa Barbara, **supra**.*

84. The result in Penner was anticipated by the SBE. For instance, see *Corr* dated September 19, 1990, wherein the transfer by a husband and wife of community property to a partnership in which they have 98 percent interest through a revocable living trust and their daughter and son each have individual 1 percent ownership interests was found to be a change in ownership because of the failure to comply with Section 62(a)(2).

85. Penner, *id*, at 1678, referring to Stats. 1987, ch. 48, Section 2, p. 123.

86. Obviously, these kinds of examples are for well-propertied clients considering the estate tax to be paid as a result of transfers by H and W.

87. *id.*, see Note 38 above.

88. The gift of 1% of full cash value in Year 1 is $39,780 (.01 x $3,978,000) and in Year 2 is $40,576 (.01 x $4,057,560) so that the amount of given by each is: 955,500 + $39,780 + 40,576 = $1,035,856.

89. For changes in control of the entity under Section 64(c), see Revenue & Taxation Code Section 480.1. For changes in ownership under Section 64(d) see Revenue & Taxation Code section 480.2. In both cases the appropriate form must be filed with the State Board of Equalization in Sacramento.

90. See Montgomery Ward & Co., Inc. v. The County of Santa Clara (1996) 96 Daily Journal D.A.R. 9056.