



California Property Tax Change in Ownership Orange County Study Group

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Proposition 13 added Article XIII A to the California Constitution

- Set maximum amount of property tax to 1% of the full cash value
 - Plus local add-ons for certain bonded indebtedness
- Rolled back property full cash values to the assessor's valuation on the 1975 lien date value, factored forward to 1978
 - Known as the "original base year value", effective beginning with the 1978-79 fiscal year
- Restricted annual increases in assessed value to an inflation factor, not to exceed 2% annually
 - Factored value is known as the "adjusted base year value"
- Prohibited reassessment of a new base year value except upon: (a) a change in ownership; or (b) completion of new construction
- Proposition 8 amended Article XIII A in November 1978 to guarantee reassessments in declining markets
 - RTC § 51(a)(2)

Definition of Change in Ownership

Revenue and Taxation Code § 60 sets forth three elements that define “change in ownership”. A change in ownership means:

- A transfer of a *present interest* in real property (right to immediate possession, use or enjoyment, excludes transfers of future and contingent interests)
- Including the *beneficial use* thereof (right to occupy, right to income, right to transfer)
- The value of which is *substantially equal to the value of the fee interest* (protects transfers of short-term estates and leaseholds)

Changes in Ownership – RTC § 61

Examples of changes in ownership – transfer of real property interests:

- entering, transfers or terminations of 35+ year leases (including options)
- creations, transfers or terminations of certain JTs
- creations, transfers or terminations of certain TICs
- vesting of a remainder or reversion (after end of life estate or other interest)
- vesting in beneficiary when a revocable trust becomes irrevocable
- transfers between a legal entity and any other person
- transfer of lifetime income interest in trust from one beneficiary to another (RTC § 61(g); *Reilly v. City and County of San Francisco* (2006) 142 Cal.App.4th 480; *Phelps v. Orange County Assessment Appeals Board No. 1* (2010)187 Cal.App.4th 653.)

Not Changes in Ownership - RTC § 62

Exclusions from change in ownership – transfer of real property interests:

- between spouses and between registered domestic partners
- parent-child/grandparent-grandchild
- certain trusts
- reserve an estate for years/life estate in the transferor
- certain long-term leases: lessor's reversion if < 35 years, lessee's interest if 35+ years
- certain cotenancy interests (new in 2013)
- proportional ownership interests**

Trusts

There are two general trust transfer “into/out of” rules under Rule 462.160(a) and (c), but they are consumed by the exceptions:

1. “Into” - transfer by the trustor, or any other person, of real property into a trust is a change in ownership of such property at the time of the transfer - Rule 462.160(a)
2. “Out of” - termination of a trust, or portion thereof, constitutes a change in ownership at the time of the termination of the trust - Rule 462.160(c)

Exceptions consume these rules because there is no CIO unless there is a transfer of beneficial interest -- we “look through the trust” for beneficial ownership

Remember, the trustee NEVER owns the property for property tax purposes.

Trusts – Exceptions to “Into” Rule – Rule 462.160(b)

- Revocable trusts
- Interspousal trusts
- Parent-child/grandparent-grandchild trusts
- Proportional interest trusts
- Irrevocable trusts – a transfer into an irrevocable trust where the trustor is the present beneficiary is not a change in ownership, but there is a change in ownership when people other than the trustor become present beneficiaries, unless an exclusion otherwise applies (spousal, RDP, parent-child, grandparent-grandchild)
- 12-year reversion trusts
- “Other trusts” – from one of these types of trusts to another

Trusts – Exceptions to “Out of” Rule – Rule 462.160(d)

- Revocable trusts – back to the trustor
- 12-year trustor reversion trusts – reversion back to the trustor
- Interspousal trusts
- Parent-child/grandparent-grandchild trusts
- Proportional interest trusts
- “Other trusts” – from one of these types of trusts to another
- ** Prior change in ownership - there is no change in ownership if the property is being transferred out of a trust according to its terms to the person or entity who already had a present interest in the property (either use of or income from the property) while it was in the trust, either when the trust was created, when it became irrevocable, or at some other time

Lifetime Income Interests in Trust – *Reilly*

Reilly v. City and County of San Francisco (2006) 142 Cal.App.4th 480.

- Trustor died in 1966 – will created testamentary trust, which provided for net income to grandniece for her life, and after her death, net income to the trustor's nephew for his life.
- The assessor determined that a change in ownership occurred when the nephew succeeded to the grandniece's income interest upon her death.
- Court of Appeal held:
 - When a new lifetime income beneficiary succeeds another beneficiary, there is a change in ownership of the property. This is the case even though the interest is only the income interest and not the right to occupy the property.
 - Because a change in ownership occurs upon the creation of a life estate in income from real property unless an exclusion applies, it follows that the termination of such a life estate followed by the creation of a new life estate in income from the property would also qualify as a change in ownership, subject to statutory exclusions.

Life Estates and Estates for Years

Governed by RTC §§ 61(g), 62(e), Rule 462.060, Reilly and Phelps

- The creation/transfer/termination of a life estate or estate for years 35+ years is a change in ownership.
- Life estate/estate for years rules apply to lifetime or estate for years income interests *inside and outside of trusts*.
- Think of every transfer to a trust with successive beneficiaries as having a grantor of a life estate (trustor), life tenant (current beneficiary), maybe successive life tenants/"remainderman" after first life tenant (successive lifetime beneficiaries), and remainderman (final beneficiary/principal distributee) or reversion (trustor).
- To determine the change in ownership consequences, apply the life estate/estate for years rules on the successive income interest transfers as if the transfers were transfers of real property happening outside of a trust.

Trust Sprinkle/Spray Provisions

- Under Rule 462.160(b)(1)(A), when a trustee has a sprinkle power to distribute trust property or income from the property to a number of potential beneficiaries, unless all of the potential beneficiaries qualify for an exclusion from change in ownership at the time of the transfer (interspousal, RDP, parent-child, grandparent-grandchild), the property is subject to change in ownership because the trustee could potentially distribute the income or property to a non-excludable beneficiary.
- Example 2 from Rule 462.160:

Husband transfers property to trust and gives Wife, the trustee, a sprinkle power for the benefit of herself, her two children, and her nephew. Change in ownership of all property transferred to the trust, because the sprinkle power could be exercised for the benefit of nephew for whom no exclusion is available.
- Issues: Open class of beneficiaries not yet born – BOE view
 Legal entity interests (later)

Interspousal/Registered Domestic Partner Exclusion

RTC §§ 62(p), 63, Rule 462.220

Very broad – the following interspousal/RDP transfer are not changes in ownership:

- Transfers in and out of trusts
 - Transfers that take effect on death
 - To current/former in connection with a property settlement agreement, decree of dissolution of marriage/partnership, or legal separation
 - Creation, transfer, or termination of any co-owner's interests
 - Distribution of a legal entity's property to a current or former in exchange for that person's interest in the entity, in connection with a property settlement agreement, decree of dissolution of marriage/partnership, or legal separation
 - Legal entity transfers even if change in control under RTC § 64(c)(1) or change in ownership under RTC § 64(d)
 - BUT – no disproportionate transfers to legal entities **
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Transfers of Real Property to/from Legal Entity

Governed by RTC §§ 61(j), 62(a)(2), 64(b) and Rule 462.180

- **Basic Rule:** Transfers of real property interests (fee interests, certain leaseholds) to or from a legal entity results in a change in ownership under RTC § 61(j), which states that a change in ownership includes,

The transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner, or any other person.
- **Exclusions:** The transfer is a change in ownership (reporting requirements attach) but it is not reassessable if the transfer qualifies for the proportional ownership interest transfer exclusion under RTC § 62(a)(2), or a transfer between affiliated corporations under RTC § 64(b).

Penner v. County of Santa Barbara

37 Cal. App. 4th 1672 (1995)

- Mother owned real property 100% in fee by herself and transferred it to a FLP in which she and her children were partners.
- Transfer was between a person and a legal entity under RTC § 61(j), and because it was disproportionate, not excludable under RTC § 62(a)(2).
- Because the children did not receive real property directly from the mother, the parent-child exclusion did not apply.
- Mother argued result would have been the same if multiple steps had been taken by first transferring the property from herself to herself and the children as tenants in common, followed by all of them transferring it into the FLP proportionately. Therefore, she argued, the transaction should be treated as a single transaction under the step transaction doctrine.
- Court of Appeal acknowledged that if the multiple steps had been taken, the parent-child exclusion and then the proportional ownership interest transfer exclusion under RTC § 62(a)(2) would have applied. However, the step transaction doctrine allows the assessor to ignore certain steps that are taken, but does not allow a taxpayer to invent steps that never existed.

Legal Entity Interest Transfers

- Principal rule is RTC § 64(a) -- transfers of interests in a legal entity do not result in the transfer of the entity's real property
- There are two principal exceptions:
 - If there is a “change in control” of the entity under RTC § 64(c)(1)
 - If there is a “change in ownership” of the entity under RTC § 64(d)

Legal Entities - Change in Control – RTC § 64(c)(1)

- “Change in control” occurs when a single person or entity obtains:
 - direct or indirect ownership or control of more than 50% of a corporation’s voting stock, or
 - direct or indirect ownership of more than 50% of the total interest in capital and profits in any partnership or LLC
- Result: a 100% reassessment of all real property owned by the entity (including certain leaseholds and reversionary interests)
- Unlimited statute of limitations if not reported

Legal Entities - Changes in Ownership – RTC § 64(d)

- “Change in ownership” occurs:
 - Cumulatively > 50% of the entity interests have been transferred by the “original co-owners”
- When are entity owners are “original co-owners”?
 - Property was transferred to the entity using the proportional ownership interest transfer exclusion
- Most entities and owners unaware/ignorant of this rule
- Property reassessed – just that transferred to the entity
- Unlimited statute of limitations if not reported
- Consider having tax representatives track these transfers

Legal Entity Interest Transfers - Exclusions

- Even if there if there is a change in control under § 64(c)(1)
 - the proportional ownership interest transfer exclusion under Rule 462.180(d)(4) may apply;
 - the interspousal or RDP exclusion may apply (RTC §§ 62(p), 63, Rule 462.220); or
 - the transaction may qualify as reorganization among affiliated corporations under RTC §§ 64(b)
- Even if there is a change in ownership under RTC § 64(d)
 - the counting and cumulating might be excluded under Rule 462.180(d)(2) as proportional, or between spouses or RDPs

Changes in Control and Ownership in Trust

- Rule 462.160(b)(1)(C) – the rules regarding change in ownership of legal entities apply regardless of whether the interests are held in trust.
- Example 4 from Rule 462.160:
 - H and W are the partners of LP and are not original co-owners. They transfer 70% of LP to an irrevocable trust with their four children as equal present beneficiaries. RTC § 64(a) applies and neither exception in RTC § 64(c)(1) or § 64(d) applies because no child obtains more than 50% of LP. So there is no change in ownership.
- Instead, assume that there is just one child as the beneficiary – there would be a change in control under RTC § 64(c)(1) because the one child obtains > 50% of LP.
- Instead, assume that H and W were original co-owners – there would be a change in ownership under RTC § 64(d) because H & W transferred > 50% of LP.
- Instead, assume that there were two children, and one of the children had the right to 70 percent of the trust income (H and W still not original co-owners). No change in ownership --> 70% of the income x 70% of the partnership = right to 49% of LP.
- Most of these changes in ownership are not caught until years later.

Sprinkle Powers and Legal Entities

Rule 462.160 has a sprinkle power provision in subdivision (b)(1)(A) that says that when property is transferred to an irrevocable trust, if the trustee has a power to distribute income or principal to a number of potential beneficiaries and all of them do not qualify for either the interspousal/RDP, parent/child or grandparent/grandchild exclusion, there is a change in ownership.

What is the result with legal entity interests when they are transferred to such a trust?

RTC § 64(c)(1), regarding changes in control, requires a person *actually obtain* the controlling interest (ownership or control of corp voting stock, ownership of capital & profits of partnership or LLC)

RTC § 64(d) only requires the original co-owners to transfer their interests. It looks at what the transferor got rid of.

Can your clients avoid reassessments of legal entities using sprinkle powers?
What is the result when such interests are distributed out of the trust?

Parent-Child Exclusion - RTC § 63.1

- Real property *between* parents and children (both directions)
- No legal entity interests
- Owned by transferor – no after acquired property
- Unlimited principal residences
- \$1 million “other property” – full cash value meaning assessed value
- \$1 million is per transferor separately
- First properties transferred take \$1 million first
- Multiple properties on same day, transferees must decide
- Two transferors can combine on jointly transferred property

Grandparent-Grandchild Exclusion - RTC § 63.1

- Only transfers from grandparent to grandchild, not vice-versa
- All “parents who qualify as children of the grandparents” must be deceased
- Son- or daughter-in-law of the grandparent that is a stepparent to the grandchild need not be deceased
- A probate code disclaimer does not make disclaimant “deceased”
- Be careful with GSTs, review BOE Annotations:
<http://www.boe.ca.gov/lawguides/property/current/ptlg/annt/625-0000-all.html>,
and
<http://www.boe.ca.gov/lawguides/property/current/ptlg/annt/493-0000-all.html>
- Exclusion only applies to the extent the deceased parent’s \$1 million exclusion was not fully used
- Principal residence may go to grandchild only if haven’t received one from parents – otherwise, must dip into the \$1million

Non-Pro Rata Distributions and Parent-Child/Grandparent-Grandchild Transfers

- If sufficient assets to equalize, no problems so long as the FMV of the property does not exceed the child/grandchild's share of the entire estate.
- If there are insufficient assets to give the real property to one child and equalize distributions with the other children, the trustee may encumber the real property with a loan and equalize the value of the other beneficiaries' interests in the trust assets by distributing to them the cash loan proceeds.
- The transfer to the child/grandchild obtaining the property will still qualify for the exclusion so long as the value of the property does not exceed his or her interest in the total trust estate.
- *** The loan may not be made by the person obtaining the property, which would be viewed as a payment from that child to the other beneficiaries, but may be made by the other beneficiaries.

Parent-Child Exclusion - Uncodified Language

In the notes following RTC § 63.1, the legislature added the following language of legislative intent, recognizing that because the parent-child exclusion did not apply to legal entity interests, it may be necessary to take property out of a legal entity to use the exclusion, and in certain cases the step transaction doctrine should not apply. The note states:

Specifically, transfers 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 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 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.

Disclaimers

- Annotation 625.0081 – a beneficiary may disclaim any interest under the probate code; properly executed disclaimer results in the interest descending as if disclaimant had predeceased creator.
- Annotation 625.0082 – parent-child exclusion may apply where children disclaim interests and property goes to other child, but agreement between kids to receive consideration for the disclaimer makes the disclaimer invalid. Children may not “quitclaim” their interests to their siblings.
- Middle generation “child” of grandparent (“parent” of grandchild) may not disclaim to make themselves “deceased” for purposes of the grandparent-grandchild exclusion. That person must actually be dead (or declared dead under the Civil Code).

Rescissions

Annotation 220.0594 (May 31, 2007) states:

Civil Code section 1688 et seq. provides for rescission of contracts, including contracts for the transfer of real property. When a contract for the transfer of real property is rescinded based upon consent of the parties, rescission must be evidenced by a written notice of rescission signed by the parties to the contract, which should be provided to the assessor. At the same time that a rescission occurs, a rescission deed or a reconveyance of title should also be recorded with the county recorder's office. The provisions of the Civil Code do not require court approval or a court order for rescission to be valid when the parties to the contract mutually agree to rescind. Rescission of a transfer of real property relates back to the formation of a contract and dissolves it as though it had never been made. Thus, once a contract is rescinded by mutual consent, the parties are placed in the same position they were in before the contract was executed. The value of the real property reverts to its previous base year value with appropriate adjustment(s) for inflation. However, in the context of property taxes, rescission has only prospective application; no refund of taxes is available to the parties for the period of time under which a conveyance is treated as a change in ownership, as the conveyance was effective for that period of time.

Note: This annotation was deleted in December 2012 because it contained inaccurate change in ownership analysis, but this annotation language states the rules on the rescission issue perfectly. See also Annotations 220.0595-220.0600,

<http://www.boe.ca.gov/lawguides/property/current/ptlg/annt/220-0000-all.html>

Real Property Transfer Filing Requirements

- Same rules for transfers of real property interests among individuals apply to transfers of real property interests and changes in ownership under RTC § 61(j) involving legal entities.
- RTC § 480(a) – file COS – non-death
- RTC § 480(b) – file COS – death
- RTC § 480(d) – may be attached to or accompany deed filed for recording
- RTC § 480(e) – if CIO document is recorded, COS must be filed with at same time, but recording still good without it
- RTC § 480(e) – within 90 days of CIO if not
- RTC § 482(a) – penalty
- RTC § 480.3 – Preliminary Change of Ownership Report (PCOR)

Legal Entity Transfer Filing Requirements

- RTC § 480.1 – changes in control under RTC § 64(c)(1)
- RTC § 480.2 – changes in ownership under RTC § 64(d)
- BOE view – still required for interspousal/RDP and proportional change in control and changes in ownership under § 64(c)(1)
- Not required for statutory conversions
- Not required for proportionate statutory mergers (but must file COS and PCOR with assessor)
- RTC § 482(b) – penalty for failure to file
- Unlimited statute of limitations
- RTC § 483(c)(1) – relief from penalty
- Annotation 565.0020 (September 10, 2010) – transfers as of death, file protectively