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South Bay Estate Planning Council

Using A Business Entity To Transfer Real Estate Without Causing A Property Tax Reassessment

BACKGROUND

A. Proposition 19

- Passed by voters in November, 2019.

Significantly changed property tax reassessment exemptions.

- Eliminated the \$1,000,000 non-residential property parent-child exemption;
- Limited the parent-child personal residence exclusion; and
- Broadened the rule for base year transfers for persons over age 55.

(i) Exclusion for Transfers Between Parent and Child

- Effective February 16, 2021, the parent child exclusion for personal residence transfers is limited:
 - a transfer of a principal residence;
 - to the children; and
 - at least one child must
 - use it as his/her primary residence; and
 - apply for the homeowner's exemption within one year of the transfer.
 - The child must continually live in the property as family home to maintain the exclusion. If it is not used as a principal residence, it will

receive a new taxable value as of the date it is no longer used as a child's principal residence.

- No longer unlimited.
 - If the property's FMV is:
 - **less** than the assessed value plus \$1,000,000, no property tax reassessment.
 - **greater** than the assessed value plus \$1,000,000, reassessed on the difference. The difference is added to the assessed base value.

- **Example:**

Residence with a \$300,000 assessed value and a \$1,500,000 FNV.

Since the \$1,500,000 FMV > \$1,300,000 [\$300,000 + \$1,000,000], the \$200,000 difference is added to the assessed value.

Thus, the new base year value is \$500,000 [\$300,000 (original base) + \$200,000].

B. Exclusion From Change in Ownership ("CIO") That Survived Prop 19

(i) Interspousal/Registered Domestic Partner Exclusion (R&T Code §63)

- Transfers between spouses of an undivided interest in real property is not a CIO; and
- Transfer of interests in legal entities between spouses are not counted for purposes of the R&T Code §64(d) "original co-owner" rule.
- **Note: Disproportionate transfers to legal entities is a CIO**
 - **Example:** H cannot transfer his separate property to an LLC owned 50/50 by H & W. That is a disproportionate interest transfer.
 - A transfer from H and W as community property to an entity owned by H & W 50/50 qualifies for the proportional interest transfer.

(ii) Transfer of Real Property Into and Out of Legal Entities

- **General rule:** A transfer to or from a legal entity or between legal entities is a CIO (R&T §61(j)).

- **Exception:**

a. Proportional Ownership Interest Transfer Exclusion (R&T §62(a)(2)). (At the end of these materials)

- Any transfer of real property between an individual or individuals and an entity, or between legal entities, that only results in a change in the **method of holding title** to the real property, and in which the proportional ownership interests of the transferors and transferees in each and every piece of real property transferred remain the same after the transfer, is not a CIO.
- ***The entity is now an original co-owner under R&T Code §64(d) (at the end of these materials).***

b. Change in Control: R&T Code §64(c) (at the end of these materials):

1. The transfer of an ownership interest in a legal entity that results in a **change in control** of that entity is a CIO of the real property the entity owns.
2. A person or entity obtains direct control when it acquires:
 - (i) ownership or control of more than 50% of a corporation's **voting** stock;
 - (ii) more than 50% of the total capital and profits interest in any partnership or LLC; or
 - (iii) more than 50% of the total ownership interest in any other entity.
3. There are no attribution rules between spouses and related parties.

Ocean Avenue LLC v. County of Los Angeles, 227 Cal. App 4th 344 (2014).

This is known as the “Michael Dell” case.

The Ocean Avenue, LLC, which owned the Fairmont Miramar Hotel, was acquired by Michael (42.5%), his wife (49%) and an adviser (8.5%). This did not cause a CIOA because no one person received more than 50% of the membership interests in the LLC.

c. Change in Original Co-Owner §64(d)

1. An **original co-owner’s** transfer of an ownership interest in a legal entity that results in a **cumulative transfer** of more than 50% of the original co-owners’ interests is a CIO.
 - (i) **Example:** “A” transfers property to single member LLC. There is no CIO under the proportional interest exclusion, but “A” becomes an original co-owner. A transfers a 50% membership interest to “B.” There is no CIO because there has not been a transfer of more than 50% of the original co-owner’s interests. “A” then transfers 1% to “C.” There is a 100% reassessment.
 - (ii) **Trap:** Effective for transfers on or after March 1, 1975.
 - (iii) Only come under the original co-owner rule if the proportional interest transfer exclusion was applied (R&T §62(a)(2)).

Example: An individual buys property in his/her own name and then transfers it to an LLC (or other legal entity).

1. Advice to Clients:

- a. Always buy Property in an LLC or partnership to come under R&T Code §64(c) change in control rule and to avoid the §64(d) original co-owner rule.
- b. If you are forced to buy a property in your own name, e.g., due to a lender, immediately transfer it to an entity. If you get a call from the Assessor, don’t respond and let them reassess it. Who cares? Don’t apply for proportionate interest transfer exclusion.

- (iv) **Caution:** Review the prior grant deeds and the Assessor's portal.
- (v) When a reassessment the "original co-owner" taint is gone.

C. Traps for Estate Planning Attorneys

(i) Funding Bypass Trust with Interest in Entities:

- a. If the spouse and children are the Bypass Trust beneficiaries, add a saving clause to the Living Trust to avoid a reassessment.
- b. **Example:**

The Living Trust owns a 52% Membership Interest in an LLC; the other 48% is owned by the children or third party.

The real property was contributed to the LLC as a proportional interest transfer under R&T Code §62(a)(2) so it falls under R&T Code 64(d).

The estate planning attorney funds the Bypass Trust with the children and spouse as beneficiaries with the 52% membership interest.

This is a §64(d) CIO since it is a transfer of more than 50% of the original co-owner interest.

It does not qualify for spousal exclusion (§63) because the spouse was not the sole Bypass Trust beneficiary.

Planning:

- (i) Children disclaim their interest in the Bypass Trust
- (ii) Saving clause in Living Trust. (Email me for a copy.)

(ii) Change in Trust Beneficial Ownership Triggers CIO

- a. end of QPRT/ GRAT term.
- b. Death of a Spouse in Marital Trust.

- c. Child's death and application of the R&T Code §64(d) original co-owner rule.

(iii) Transfer of Interest in Legal Entities to an Irrevocable Children's Trust with Sprinkle Beneficiaries

a. Rule 462.160 (c) Example 4:

H&W, partners in HW Partnership, who are **not original co-owners**, transfer 70% of their partnership interests to HW Irrevocable Trust and name their **four children as the present equal beneficiaries**.

H&W do not retain a reversion right.

Under §64(a), the transfer of the partnership interests to HW Irrevocable Trust is excluded from CIO because no person or entity obtains a **majority ownership interest** in the HW Partnership."

b. Planning: Must Create Separate Shares for each child or Assessor argue:

Assume the trustee has discretionary authority or the trust has sprinkle/spray provisions.

In that case, no beneficiary has a set percentage interest. Distributions can be made on a non-pro rata basis.

That is regarded as a change in control, per Property Tax Rule 462.160 (b)(1) and (2), since one of the beneficiaries could receive controlling interests (greater than 50%).

Therefore, a §64(c) change in control will occur when over 50% interests in a legal entity transfer to the trust like this even though no distribution have been made.

D. Planning Alternatives Going Forward.

(i) Residence

a. Transfer residence to a QPRT.

While the transferor retains a term of years, there is no property tax reassessment. When the term ends, there may be a property tax reassessment.

Planning: Make the spouse the sole QPRT remainder beneficiary.

b. **Transfer residence to a Spousal Lifetime Access Trust (SLAT)**

While the spouse is the sole lifetime beneficiary, the transfer should qualify for the interspousal exclusion (R&T Code 63).

(ii) Investment Property

Transfer property to an LLC and gift/sell only a 50% Membership Interests to children. After a period of time, dissolve the LLC to remove the original co-ownership taint and form a new LLC. At death of parent, provided no beneficiary gets more than 50% (i.e. control), there should not be a CIO.

(iii) Combination of SLAT and LLC

Step 1:

Transmute property to SP of each of Husband and Wife ("H and W")

Step 2:

H and W transfer their SP to an LLC.

Step 3:

After a period of time, H transfers 49% of his interest to a SLAT for W in a part sale, part gift transaction.

No property tax reassessment as this is a transfer between spouses and is not counted toward the original co-owner rule.

Step 4:

W transfers 49% of her LLC interest to a Nevada Children Trust for the children (the Protector can add the spouse in as a discretionary beneficiary if needed).

No property tax reassessment as it is not a transfer by an original co-owner of more than 50%.

Step 5:

After the 3-year gift statute of limitation expires, dissolve the LLC and hold the property as tenants in common: SLAT as to 49%, Nevada Children's Trust as to 49% and 1% separate property H, 1% separate property W.

Step 6:

H and W transfer their 1% undivided interest to the Nevada Children's Trust. The Nevada Children's Trust now owns 51% and SLAT owns 49%.

Step 7:

Create a new entity and transfer the SLAT and Children's Trust interest proportionally (51%-49%)

Step 8:

When the spouse who is the sole SLAT beneficiary dies, there should not be a property tax reassessment as less than a 50% change in the original co-owners.

Step transaction may apply if W dies soon.

- Under this alternative, you can reduce the estate without waiting 4-6 years as required in other planning alternatives.

ENTITY EXAMPLES

Alternative 1: A Residence: 49 – 2 – 49.

(1) 2021.

Parent transfers the property into an LLC.

(2) 2022.

Parent gives the child 49% of the membership interests.

(3) 2023.

- a. Dissolve the LLC. This should result in losing the first LLC's "taint."
- b. Hold the property as tenants in common: 51% parent, 49% child.

- c. Parent gives 2% tenancy in common interest to the child. That 2% is reassessed.
- d. To be safe, parents pay rent on the 51%.

(4) 2024.

- a. Form a new LLC.
- b. Parent and child transfer their tenancy in common interests into the LLC and become 49% - 51% members in the new LLC.

(5) 2025.

- a. Parent gives the 49% membership interests to the child.
- b. No reassessment under §64(c)(1) as child was already in control.
- c. Parent pay rent for the 51%.

(6) Parent's Death.

There is nothing to be reassessed. (See "Caution" below.)

**Alternative 2: Non-Residence Real Property.
Parent Does Not Need The Rent.
49 – 2 – 49.**

Same as above for Residence.

**Alternative 3: But no need to worry about Parent paying rent.
Non-Residence Real Property.
Parent Does Not Need The Rent.
50 – 50.**

(1) 2021.

Parent transfers the property into an LLC.

(2) 2022.

Parent gives the child 50% of the membership interests.

(3) 2023.

- a. Dissolve the LLC.

- b. Hold the property as tenants in common.

(4) 2024.

- a. Form a new LLC.
- b. Parent and child transfer their tenancy in common interests into the LLC and become 50 - 50 members in the LLC.

(5) 2025.

Parent gives 50% membership interest to the child.

(6) Parent's Death.

The property will not be reassessed.

(7) Caution.

Spreading the steps out over this number of years does not prevent the State Board of Equalization from arguing that the Step Transaction applies. The greater the number of years between the steps, the more conservative the structure. There should be no discoverable paperwork (which includes email) describing this series of steps.

Alternative 4: Non-Residence Real Property- Parent Needs The Rent.

(1) 2021.

Parent transfers the property into an LLC.

(2) 2022.

- a. Property is appraised for fair market value. Assume \$1,000,000.
- b. Parent sells the child 50% of the membership interests for \$500,000.
- c. Child pays with \$50,000 down and a \$450,000 note.¹
- d. The note is designed to return \approx 50% of the rent to the Parent.²

¹ Parent pays capital gain tax on the \$50,000 down payment. The \$450,000 note might be 30 years, interest only, meaning the capital gain tax on that amount may be deferred for 30 years.

² \$450,000 interest only at 5% is almost \$2,500 per month.

(3) 2023.

- a. Dissolve the LLC.
- b. Parent and Child hold the property as tenants in common.

(4) 2024.

- a. Form a new LLC.
- b. Parent and child transfer their tenancy in common interests into the LLC and become 50% - 50% members in the LLC.

(5) 2025.

- a. Property is again appraised. Assume \$1,200,000.
- b. Parent sells the Child 50% of the membership interests for \$600,000.
- c. Child pays \$60,000 down and a \$540,000 note.³
- d. The note is designed to return \approx 50% of the rent to the Parent.⁴

(6) Parent's Death.

The property will not be reassessed.

Alternative 5: Spousal Lifetime Access Trusts ("SLAT").

Assume \$100,000,000 of real estate.

- Step 1:** Transmute property to separate property ("SP") of each of Husband and Wife ("H and W").
- Step 2:** H and W transfer their SP to an LLC.
- Step 3:**
 - 3.1.** After a period of time, H transfers 49% of his LLC interest to a SLAT for W in a part-sale, part-gift transaction.
 - 3.2.** No property tax reassessment as this is an inter-spousal transfer which does not count towards the original co-owner rule.
- Step 4:**
 - 4.1.** W transfers 49% of her LLC interest to a Nevada Children's Trust under which the Protector can add H as a beneficiary.

³ Parent pays capital gain tax on the \$60,000 down payment. The \$540,000 note might be 30 years, interest only, meaning the capital gain tax on that amount may be deferred for 30 years.

⁴ \$540,000 interest only at 5% is almost \$3,000 per month.

4.2. No property tax reassessment as it is not an original co-owner transfer of more than 50%.

Step 5: **5.1.** After the 3-year gift tax statute of limitations expires, dissolve the LLC.

5.2. Create a new one: SLAT as to 49%, Nevada Children's Trust as to 49% and 1% H's separate property, 1% W's separate property.

Step 6: **6.1.** H and W each transfer their 1% interest undivided interest to the Nevada Children's Trust.

6.2. The Nevada Children's Trust now owns 51% directly and the SLAT owns 49%.

Step 7: Create a new LLC as a proportional interest:

7.1. 51% Children's Trust.

7.2. 49% SLAT.

Step 8: When the SLAT beneficiary spouse (W) dies, there should be no:

8.1. property tax reassessment as it is less than a 50% change in the original co-owners; and/or

8.2. step transaction if W does not die soon.

Benefit: Reduce the estate without waiting the 4-6 years as in the prior 3 alternatives to avoid a property tax reassessment.

Change in ownership shall not include:

(a)

(1) Any transfer between coowners that results in a change in the method of holding title to the real property transferred without changing the proportional interests of the coowners in that real property, such as a partition of a tenancy in common.

(2) Any transfer between an individual or individuals and a legal entity or between legal entities, such as a cotenancy to a partnership, a partnership to a corporation, or a trust to a cotenancy, that results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors 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. The provisions of this paragraph shall not apply to transfers also excluded from change in ownership under the provisions of subdivision (b) of Section 64.

Section 64 - Purchase or transfer of ownership interests in legal entities not transfer of real property of legal entity; corporate reorganization

(a) Except as provided in subdivision (i) of Section 61 and subdivisions (c) and (d) of this section, the purchase or transfer of ownership interests in legal entities, such as corporate stock or partnership or limited liability company interests, shall not be deemed to constitute a transfer of the real property of the legal entity. This subdivision is applicable to the purchase or transfer of ownership interests in a partnership without regard to whether it is a continuing or a dissolved partnership.

(c)

(1) When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities, including any purchase or transfer of 50 percent or less of the ownership interest through which control or a majority ownership interest is obtained, the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained.

(2) On or after January 1, 1996, when an owner of a majority ownership interest in any partnership obtains all of the remaining ownership interests in that partnership or otherwise becomes the sole partner, the purchase or transfer of the minority interests, subject to the appropriate application of the step-transaction doctrine, shall not be a change in ownership of the real property owned by the partnership.

(d) If property is transferred on or after March 1, 1975, to a legal entity in a transaction excluded from change in ownership by paragraph (2) of subdivision (a) of Section 62, then the persons holding ownership interests in that legal entity immediately after the transfer shall be considered the "original coowners." Whenever shares or other ownership interests representing cumulatively more than 50 percent of the total interests in the entity are transferred by any of the original coowners in one or more transactions, a change in ownership of that real property owned by the legal entity shall have occurred, and the property that was previously excluded from change in ownership under the provisions of paragraph (2) of subdivision (a) of Section 62 shall be reappraised. The date of reappraisal shall be the date of the transfer of the ownership interest representing individually or cumulatively more than 50 percent of the interests in the entity.

A transfer of shares or other ownership interests that results in a change in control of a corporation, partnership, limited liability company, or any other legal entity is subject to reappraisal as provided in subdivision (c) rather than this subdivision.



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February 29, 2008

No. 2008/018

TO COUNTY ASSESSORS:

REVENUE AND TAXATION CODE SECTION 63.1:
PARENT-CHILD AND GRANDPARENT-GRANDCHILD EXCLUSION
QUESTIONS AND ANSWERS

STEP TRANSACTION DOCTRINE

24. Question: Does the step transaction doctrine apply to legal entity transfers between parents and children when they structure a transaction in a series of steps in order to use the parent-child exclusion?

Answer: No, provided the transaction is consistent with the statement of legislative intent contained in the uncodified note in Chapter 48 of the Statutes of 1987 (the legislation which added section 63.1 to the Revenue and Taxation Code), which allows the parent-child exclusion for certain step transactions involving legal entities.

*For example, Corporation A (wholly owned by parents) transfers real property proportionally to parents who then transfer the same real property to their child who transfers the same real property to Corporation B (wholly owned by child). The step transaction doctrine treats a series of nominally separate transactional steps as a single transaction if the steps are, in substance, interdependent and intended for a particular result. In such circumstances, however, the step transaction doctrine would not apply, and the property may be excluded under the parent-child exclusion pursuant to the statement of legislative intent. Please note that the child must file the parent-child claim form *before* the property is transferred to Corporation B (a third party transfer).*

¹² Annotation 220.0375.015.

25. Question: A mother owns real property. She transferred the property to a family partnership, in which the mother and her two children equally own partnership shares. Because the children are not receiving property directly from their mother, but rather are receiving ownership rights in the property indirectly through their ownership interests in the legal entity, such transaction would not qualify for the parent-child exclusion. However, the mother argues that the end result would have been the same if multiple steps had been taken (first, mother transfers the real property from mother to mother and children; second, both the mother and the children proportionally transfer their interests in the real property to the legal entity). Thus, the mother argues that this transaction should be treated as a single transaction under the step transaction doctrine, i.e., the transfer of real property interests from a parent to her children. Does this type of transaction qualify for the parent-child exclusion?

Answer: No. In *Penner v. County of Santa Barbara* (1995) 37 Cal.App.4th 1672, the court of appeals held that the definition of "children" as set forth in section 63.1(c)(3) "includes only natural persons with a familial relationship to one another." The court acknowledged that if the mother had first transferred the real property interests to herself and the children, and, thereafter, they had transferred the same proportional interests in the partnership, the first transfer would have been excluded from change in ownership as a transfer between a parent and her children and the second transfer would have been excluded under section 62(a)(2). In response to the argument that the parent-child exclusion should apply because the end result was the same, the court refused to depart from the plain meaning of the language of the statute. The step transaction doctrine allows certain steps actually taken to be ignored; however, it does not allow a taxpayer to invent steps that never existed.

26. Question: Can a transfer from grandparent to parent, followed by a transfer from parent to child, each qualify for the parent-child exclusion?

Answer: Yes, as long as each transfer is unrestricted. Chapter 48 of the Statutes of 1987 states that it is the intent of the Legislature to liberally construe section 63.1 to carry out the purpose of Proposition 58. Therefore, as long as each transfer is unrestricted and is otherwise eligible (e.g., between parents and children), the exclusion is applicable. However, if the parents were required to transfer the property to their child (that is, the grandchild), then the step transaction doctrine would apply and these steps would be collapsed into one transaction, i.e., a transfer from grandparent to grandchild. Since the parents are living, the grandparent-grandchild exclusion would not apply, and this transaction would not be excluded from change in ownership. The assessor can collapse the steps together under the step transaction doctrine if evidence exists that proves that the intent was for the grandchild to have the property.