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Change of Ownership: What Triggers a Property Tax Reassessment?

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Most attorneys transferring property for estate planning purposes are transferring their client's home into a revocable living trust for the benefit of the trustors who created it. There are pitfalls to watch for when completing such transfers.



THERE ARE A FEW ASPECTS OF CHANGING property ownership that attorneys should be aware of during the process. First, be careful not to transmute separate property inadvertently. Joint tenancy property may need to be re-titled as community property for income tax purposes. A Preliminary Change of Ownership Report must be filed with the transfer deed to advise the county assessor's office that such a transfer is not a change of ownership pursuant to California Revenue and Taxation (R&T) §62(d), and therefore excluded from reassessment.

Death of a Trustor, Joint Tenant, Spouse, Registered Domestic Partner or Trustee

Upon the death of a trustor of a married couple's revocable trust, there are often transfers between exemption trusts, marital trusts and survivor's trusts, all of which are excluded from reassessment as they continue in trust for the benefit of the surviving spouse trustor (R&T) §63(a). Again, a Preliminary Change of Ownership Report must be filed when recording Affidavits Death of Joint Tenant, Spouse, Registered Domestic Partner (RDP) or Trustee, advising the assessor as to why the transfer is excluded from reassessment. A transfer because of the death of a spouse or RDP, or a continuing interest in a trust for the benefit of the trustor's spouse or RDP, are excluded from reassessment as they are not deemed a change in ownership under R&T §62.

Upon the death of the second spouse or RDP, or upon the death of a single trustor, if real property is to pass to children, there are additional reporting requirements to be made to the assessor's office (generally within three years of the date of death and before any sale) so that the children will keep their parents' property tax base and the property will not be reassessed. The same rules apply for a transfer from a parent to a child (or from a child to a parent) during the transferor's life, whether the transfer is made by gift or by sale.

Parent-Child Transfer Exclusion Rules

It is important to understand the parent-child transfer exclusion rules, as there are limits to how much property can be transferred and what type of property can be transferred.

First, under R&T §63.1(a)(1), the purchase or transfer of real property which is the principal residence of an eligible transferor, in the case of a purchase of transfer between parents and their children, is excluded from reassessment. A principal residence means a dwelling that is eligible for a homeowners' exemption or a disabled veterans' exemption as a result of the transferor's ownership and occupation of the dwelling.

Second, under R&T §63(a)(2), the purchase or transfer of the first \$1,000,000 of full cash value (the assessed value) of all other real property of an eligible transferor, in the case of a purchase or transfer between parents and their children, is excluded from reassessment.

Often, children will inherit their parents' home upon the surviving parent's death whether the home is worth \$100,000 or \$10,000,000, so long as it was the principal residence of the transferor. The property will not be reassessed upon the timely filing of a Claim for Reassessment Exclusion for Transfer Between Parent and Child.

If the children are inheriting real property other than a principal residence, and the values of the other properties exceed \$1,000,000 in full cash value, it is important to evaluate whether or not there are two parents' exclusions that can be utilized (if parents were married and properties were being held for the surviving spouse, this will apply),

and which properties should be used for purposes of the exemption.

Generally, properties owned by the parents the longest with the lowest assessed value for property tax purposes, should provide the most annual cost savings to the children. Property purchased more recently or property that has been improved significantly may not be the most effective use of the parent-child exclusion. Using a graph to list all of the real property, the assessed values as of the date of death, the fair market value as of the date of death, any decrease in the base value, and whether or not both parents have exemptions, will be helpful in determining which properties have the lowest property tax base, and how much of it can be used with each parent's \$1,000,000 other property exclusion.

From a practical standpoint, depending on whether or not more than one child is receiving a share in each property, or if each child is receiving an interest in different properties with an intent to equalize the value of the exclusions, percentages of properties can be used for reassessment exclusion purposes (i.e., 20 percent of a property can be chosen to be excluded from reassessment instead of the entire property).

In very narrow circumstances a transfer between grandparents and their grandchild or grandchildren can be excluded from reassessment. If the parent of that grandchild or grandchildren, who qualifies as the child of the grandparent, is deceased as of the date of purchase or transfer, a transfer to the grandchild or grandchildren will be excluded from reassessment under R&T §63(a)(3)(A).

Sunset Tax Laws

Many individuals are currently transferring assets out of their estate to lower the value of their taxable estate upon their deaths, taking advantage of the unique 2011 and 2012 circumstances which combined, make real estate a logical asset to gift to children. First, the Federal Lifetime Gift Tax Exemption in 2011 is \$5,000,000 (indexed for inflation in 2012 is \$5,120,000). Second, the value of real estate these past four years is significantly lower than real estate values during the past decade.

Using entities such as Family Limited Partnerships and Limited Liability Companies allow parents to continue to control the assets, earn management or general partner income, and give minority interests in the entities to their children at considerable value discounts.

Legal Entities

There are separate exemption rules for transfers involving legal entities, such as corporations, LLCs and partnerships. Transfers of interests in legal entities between parents and children do not qualify for the parent-child exclusions because R&T §63(c)(8) limits the exclusion to transfers of real property. For this purpose, trusts are not considered legal entities.

If an entity purchases real property, the result is a reassessment. That entity will not suffer a reassessment in the future, unless a change in control occurs, i.e., when a person or entity which did not own more than 50 percent of the ownership then engages in a transaction or transactions which results in that person or entity now owning more than 50 percent (R&T §64(c)(1)).

Transfers of real property to or from an entity are exempt from reassessment, if the ownership interests of the transferor and transferee are identical (R&T §62(a)). If the transferee is the entity, the owners are known as the original co-owners. That entity can then be subsequently reassessed

in two ways. First, reassessment occurs if a change in control takes place, resulting in a new owner who owns more than 50 percent of the entity. Second, reassessment is triggered if the original co-owners cumulatively transfer more than 50 percent in the entity, resulting in a change of ownership (R&T §64(d)).

For example, assume parents own a property they propose to include in an LLC, and want 49 percent of the LLC to be ultimately owned by their two children. The alternatives are:

1. The parents transfer the property to the LLC, in which they are the only members. The transfer is exempt from reassessment because the ownership of the transferor and transferee are identical. The parents become the original co-owners, and subsequently transfer 49 percent of the LLC to their children. There is no change in ownership because there is not yet a cumulative transfer of over 50 percent. The parent-child exemption does not apply to a transfer of an interest in an entity, and the \$1,000,000 limitation on the parent-child exemption is not applicable.
2. The parents can transfer a 49 percent interest in the property to the children, which would qualify for the parent-child exemption, subject to the \$1,000,000 limitation(s). The family members can subsequently transfer their interests in the property to the LLC, and such interests are exempt from reassessment because the ownership of the transferor and transferee are identical.

Section 64 of R&T provides that a single member LLC undergoes a change of ownership if a person or entity acquires more than a 50 percent interest in the LLC. It appears that the legal standing of the single member LLC is respected for property tax purposes, and the single member LLC is not treated as a disregarded entity as it is for income tax purposes.

Transfers of interests in legal entities, unlike direct transfers of properties, do not involve deeds recorded and made public. However, if either a change in ownership or change in control as previously defined occurs with respect to an entity, the entity is required to file a Form BOE-100-B with the Board of Equalization within 90 days of the transfer.

In addition, if the Board sends a Form BOE-100-B to the entity, it is required to file a response within 90 days, whether or not an event or events constituting either a change in control or change in ownership has taken place. New time limits are in effect as of January 1, 2012. There are penalties for not informing the authorities on a timely basis.

The property tax rules are sometimes similar to rules governing other taxes, but they have their own purposes and are unique:

- The rules with respect to documentary transfer taxes are similar, but not identical.
- The definition of principal residence has nothing to do with the various IRS definitions, and especially is not based on the two out of five years test for the \$250,000 capital gains exemptions on the sale of property.

- If, for example, the parents are transferring a 49 percent interest to their children, the assessor, in considering the \$1,000,000 limitation, is unlikely to accept the minority/lack of marketability discounts used in filing gift tax returns with the IRS.

Step Transactions

One tricky area in avoiding property reassessment involves multiple beneficiaries, not all of whom qualify as children. For example, the decedent leaves 80 percent of her estate to her only child and the remaining 20 percent to a non-child, and has property worth less than 80 percent of the estate.

The parties agree to leave all of the property to the child, in order to qualify for the exemption. The balance of the estate benefits the non-child to the extent of the 20 percent interest, and the remainder to the child. In this case, the assessor may challenge the transfer and refuse to allow the exemption to 20 percent of the property, claiming that the 20 percent was effectively transferred to the child from the non-child in a non-exempt transaction.

Some transactions can run afoul of the step transaction doctrine, which the assessor may choose to apply in certain specific cases where it appears that a series of transfers are used to circumvent the change in ownership rules. In *Shuwa Investments Corp. v. County of Los Angeles*, 1 Cal. App. 4th 1635, 1648-1649 (1991), the California Court of Appeal set forth three tests: (1) end result test, where it could be determined that a series of transfers were really component parts of a single transaction, which the parties planned all along to be taken to reaching the end result; (2) interdependence test, where the steps taken were so interdependent that the relationships created by one transfer would have been fruitless without completing the entire series of steps, other than qualifying for the exclusion; and (3) binding commitment test, if it appears that there is an agreement that once the first transfer is taken, that the parties are then committed to implement the remaining steps.

The State Board of Equalization (SBE) stated that assessors could apply the step transaction test where taxpayers, in order to obtain a lower assessment where the market value had fallen below the assessed value, transferred the property to another party, who in turn transferred the property back to the taxpayer.

However, the legislature in R&T §63.1 stated its intent that the step transaction argument is not to be used to collapse parent-child transfers, including transfers involving legal entities. In an uncodified note, the Legislature stated its intent that:

“Section 63.1 of the Revenue and Taxation Code shall be liberally construed in order to...exclude from change in ownership purchases or transfers between parents and their children described therein.”

When California real property is involved, property taxes can be as important as income, estate or gift taxes. By careful planning, potentially expensive reassessments can often be avoided. ↴



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Test No. 49

This self-study activity has been approved for Minimum Continuing Legal Education (MCLE) credit by the San Fernando Valley Bar Association (SFVBA) in the amount of 1 hour. SFVBA certifies that this activity conforms to the standards for approved education activities prescribed by the rules and regulations of the State Bar of California governing minimum continuing legal education.

1. To prevent property reassessment, a Preliminary Change of Ownership Report (PCOR) must be filed with the transfer deed to alert the county assessor's office.
 True False
2. Transfers because of the death of a spouse or Registered Domestic Partner (RDP) are not deemed a change in ownership under California Revenue and Taxation Code 62.
 True False
3. A continuing interest in a trust for the benefit of the trustor's spouse or RDP will trigger a property reassessment.
 True False
4. When the trustor of a married revocable trust dies, transfers between exemption trusts, marital trusts and survivor's trusts are generally excluded from reassessment.
 True False
5. The purchase or transfer of real property, other than a principal residence of an eligible transferor, between a parent and his or her children, is excluded from reassessment for the first \$1,000,000 of fair market value.
 True False
6. If the property is the principal residence of the transferor, the property will not be reassessed even if a Claim for Reassessment Exclusion for Transfer Between Parent and Child was not filed on a timely basis.
 True False
7. Property purchased recently or property that underwent significant improvements are the properties best suited for a parent-child exclusion.
 True False
8. It is important to evaluate whether or not two parents' exclusions can be used when multiple properties with a total value of over \$1,000,000 in full cash value are inherited by the children.
 True False
9. Percentages of properties cannot be used for reassessment exclusion purposes.
 True False
10. All property transferred from a grandparent or grandparents to a grandchild or grandchildren will be excluded from reassessment.
 True False
11. It's better to wait until after December 31, 2012 to help clients transfer assets such as property because the current federal tax laws and the housing market aren't beneficial for property owners right now.
 True False
12. Parents may be able to give minority interests in Limited Liability Companies and Family Limited Partnerships to children at a considerable value discount.
 True False
13. Transfers of interests in legal entities may also qualify for the parent-child exemption.
 True False
14. A purchase of real property by an entity will generally trigger a reassessment.
 True False
15. If there is a change in control of an entity, its owned property will be reassessed.
 True False
16. So long as the parents who transfer an interest in an entity holding real property to their children retain a 51 percent interest in that entity, there will be no reassessment of the property.
 True False
17. The transfer of property interests to an entity constitutes a change of ownership, even if the owners of the entity/transferees are identical to the transferors.
 True False
18. The legal standing of a single member LLC is respected for property tax purposes, not treated as a disregarded entity as it is for income tax purposes.
 True False
19. Assessors may apply a step transaction test, questioning whether a series of transactions contributed to a single end result were sufficiently interdependent, and represented a binding commitment by the parties to implement the remaining steps of the transaction in an effort to circumvent change of ownership rules.
 True False
20. An entity is required to file Form BOE-100-B with the Board of Equalization within 60 days of a change in ownership or control.
 True False

MCLE Answer Sheet No. 49

INSTRUCTIONS:

1. Accurately complete this form.
2. Study the MCLE article in this issue.
3. Answer the test questions by marking the appropriate boxes below.
4. Mail this form and the \$15 testing fee for SFVBA members (or \$25 for non-SFVBA members) to:

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ANSWERS:

Mark your answers by checking the appropriate box. Each question only has one answer.

1. _____ True False

2. _____ True False

3. _____ True False

4. _____ True False

5. _____ True False

6. _____ True False

7. _____ True False

8. _____ True False

9. _____ True False

10. _____ True False

11. _____ True False

12. _____ True False

13. _____ True False

14. _____ True False

15. _____ True False

16. _____ True False

17. _____ True False

18. _____ True False

19. _____ True False

20. _____ True False