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Executive Director

September 24, 2007

Re: *Change in Ownership - Transfers to a Corporation*

Dear Mr. _____ :

This is in response to your July 13, 2007, e-mail to Acting Assistant Chief Counsel Robert Lambert in which you asked for guidance regarding the change in ownership consequences of a mother and her son's transfers of two separate parcels of real property to their newly formed, closely held corporation in return for common stock. After reviewing information regarding the transfers, we have concluded that both transfers constituted changes in ownership within the meaning of Revenue and Taxation Code¹ section 60; however, we did not use the step transaction doctrine to reach our conclusion.

Factual Background

On July 2, 2004, M _____ L _____ filed articles of incorporation with the California Secretary of State for a new corporation, XX Properties, Incorporated (XX Properties). On July 13, 2004, XX Properties' held its first organizational meeting. During the meeting, the chairman was authorized to issue M _____² 14,250 shares of common stock and S _____ K _____, M _____'s son, 750 shares of common stock for \$10 per share.

On July 16, 2004, M _____ executed a grant deed transferring real property having Assessor's Parcel Number 5077-022-011 (Lot 11) to XX Properties and S _____ executed a grant deed transferring real property having Assessor's Parcel Number 5077-022-012 (Lot 12) to XX Properties. Both deeds were recorded on July 30, 2004. The deeds stated that the transfers were for consideration and that the grantors and grantees in the conveyance were comprised of the same parties who continued to hold the same proportional interests in the properties after the transfers.

On August 26, 2004, M _____ signed a XX Properties stock certificate certifying that she was the registered holder of 10,000 shares of XX Properties common stock in her capacity as the President and Secretary of XX Properties. Then, on September 16, 2004, M _____ signed two

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

² M _____ L _____ is also known as M _____ Y _____ L _____ and M _____ Y _____ K _____.

additional XX Properties stock certificates, which certified that she was the registered holder of an additional 4,250 shares of XX Properties common stock and S was the registered holder of 750 shares of XX Properties common stock. Therefore, M held 95 percent of the issued and outstanding shares of XX Properties common stock and S held the remaining five percent after the initial capitalization of XX Properties.

On February 10, 2005, M filed three notices informing the California Department of Corporations about the stock transactions. According to the notices, the 15,000 shares of XX Properties common stock were issued to M and S in return for \$150,000 in property other than money. (See attached notices.)

Subsequently, the Los Angeles County Assessor (Assessor) reassessed Lots 11 and 12 as a result of the July 16, 2004, transfers to XX Properties. The Assessor determined that M and S's proportional interests in Lots 11 and 12 were not the same immediately before and after the transfers because M owned 100 percent of Lot 11 and S owned 100 percent of Lot 12 before the transfers and M owned 95 percent and S owned 5 percent of both lots after the transfers. However, you disagreed with the Assessor's determination and filed an appeal, which is scheduled for a hearing before the Assessment Appeals Board on September 26, 2007.

You contend that M owned 100 percent of XX Properties after the July 16, 2004, transfers since she signed the stock certificate certifying that she was the registered holder of 10,000 shares of XX Properties common stock on August 26, 2004, and she did not sign the stock certificate certifying that S was the registered holder of 750 shares of XX Properties common stock until September 16, 2004, and that M only signed S's certificate because she wanted S to have a stake in what she owned. In reaching the decision to reassess both lots, the Assessor applied the step transaction doctrine to the stock issuances and found that the "end result test" allowed the Assessor to view the stock issuances as one transaction so that M could not be treated as the 100 percent owner of XX Properties from August 26, 2004, until September 16, 2004. Therefore, you have asked whether the Legal Department is of the opinion that the Assessor correctly applied the step transaction doctrine to the transfers of the two parcels in question.

Discussion

Section 60 defines a change in ownership as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." Section 61, subdivision (j), supplements section 60 and further provides that "the transfer of any interest in real property between a corporation, partnership, or other legal entity and a shareholder, partner, or any other person" is a change in ownership, unless an exclusion from change in ownership applies. Therefore, unless an exclusion applies, both M's and S's July 16, 2004, transfers of Lots 11 and 12, respectively, to XX Properties constituted changes in ownership.

1. The Proportional Transfer Exclusion (Section 62, subd. (a)(2))

Section 62, subdivision (a)(2) provides an exclusion from change in ownership for “any transfer between an individual or individuals and a legal entity or between legal entities, 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” (proportional transfer exclusion). (See Rev. & Tax. Code, § 64, subds. (a) and (c)(1).)

In order for a transfer of real property from an individual to a corporation to be proportional within the meaning of section 62, subdivision (a)(2), the transferor must own 100 percent of the same real property or portion thereof that the transferor owned prior to the transfer through the transferor’s interest in the corporation. (Property Tax Rule³ 462.180, subd. (b)(2).) A transfer is not proportional merely because the transferor receives corporate stock with a value equal to that of the transferred real property. (Property Tax Annotation No. (Annot.) 220.0083, C 10/31/89.)⁴

Therefore, when two people separately own 100 percent of two parcels of real property and transfer those parcels to a newly formed corporation in return for voting stock of equal value, the transfers will not qualify for the proportional transfer exclusion in section 62, subdivision (a)(2), unless each transferor receives a separate class of voting stock shares giving each transferor 100 percent ownership of its respective parcel of real property after the transfer. (See Property Tax Rule 462.180, subd. (b)(2); and Annot. No. 220.0375.025, C. 8/17/99; C. 3/29/2002.)

In this case, M owned 100 percent of Lot 11 and S owned 100 percent of Lot 12 before they transferred the lots to XX Properties on July 16, 2004. In consideration for the transfers, M received a 95-percent interest in XX Properties, which gave her indirect ownership of 95 percent of Lots 11 and 12, and S received a five-percent interest in XX Properties, which gave him indirect ownership of five-percent of Lots 11 and 12. Accordingly, neither M nor S’s interests in Lots 11 and 12 were the same before and after the July 16, 2004, transfers. Therefore, the transfers would not be excluded from being changes in ownership under section 62, subdivision (a)(2).

2. Agreement of the Parties

The fact that M signed a stock certificate certifying that she was the registered holder of 10,000 shares of XX Properties common stock three weeks before she signed the stock certificate certifying that S was the registered holder of 750 shares of XX Properties common stock does not mean that she was the sole shareholder during the intervening three-week period. This is because the facts indicate that at the time Lots 11 and 12 were transferred to XX Properties on July 16, 2004, there was already a contract or contracts between S, M, and XX Properties for: M to contribute Lot 11 to XX Properties in return for 95 percent of

³ Property Tax Rules are promulgated under title 18 of the California Code of Regulations.

⁴ Property tax annotations are summaries of the conclusions reached in selected legal rulings of State Board of Equalization’s counsel published in the State Board of Equalization’s Property Tax Law Guide. (See Cal. Code Regs., tit. 18, § 5200 for more information regarding annotations.)

XX Properties' common stock; and S to contribute Lot 12 to XX Properties in return for five percent of XX Properties' common stock.

Generally, when property is transferred to a newly formed corporation in return for shares of stock, the corporation issues stock certificates certifying the transferor's ownership of the agreed to number of shares soon after the property is received. However, it is common for there to be some delay between the date that a new shareholder transfers property to a new corporation and the date the corporation issues the new stockholder's stock certificates. (See 1-3 Ballantine and Sterling, Cal. Corporation Laws (4th ed.) § 54.) In such cases, issues may arise as to the time when a particular person became a shareholder.

Traditionally, the courts have not looked solely to the date that stock certificates were issued to determine the date that a particular person became a shareholder in a new corporation because it is not necessary for a corporation to issue stock certificates in order for the corporation to make a person a shareholder. (*Mitchell v. Beckman* (1883) 64 Cal. 117, 121; and *Crane Valley Land Co. v. Bank of America Nat'l Trust & Savings Assoc.* (1960) 182 Cal.App.2d 166, 173.) Instead, the courts have said that "[t]he time when a share of stock originally comes into existence, and is deemed issued, is controlled by the intent of the parties and is ascertained by examining the contract which they have executed concerning such issue" (*People v. Berber* (1951) 104 Cal.App.2d 359, 367-368); "[t]o establish the relation of a stockholder, it must appear that the minds of the parties met; that the one to whom the stock was issued agreed to be and become a stockholder in the corporation, with the privileges and responsibilities of that relation; and that the corporation accepted him as such" (*California Nat'l Supply Co. v. O'Brien* (1921) 51 Cal.App. 606, 622); and "[w]hen the corporation has agreed that a person shall be entitled to a certain number of shares in its capital, to be paid for in a manner agreed upon, and that person has agreed to take and pay for them accordingly, he becomes their owner by a valid contract made upon a valuable consideration" (*Mitchell* at p. 121).

In this case, the facts indicate that there was an agreement between S and M (acting in her personal capacity as the owner of Lot 11 and as a representative of XX Properties) to transfer Lots 11 and 12 to XX Properties in exchange for 95 percent and 5 percent of XX Properties common stock, respectively, and thereby become co-owners of XX Properties at the same time. The chairman of XX Properties was authorized to issue all of M's and S's shares at the same time at the July 13, 2004, organizational meeting; both M and S executed their grant deeds transferring their respective lots to XX Properties on July 16, 2004; and both grant deeds were recorded at the same time on July 30, 2004.

In addition, the statements in the grant deeds that the lots were transferred to XX Properties for "valuable consideration" and that the grantors and grantees of the lots were comprised of the same parties confirms that both M and S expected to receive stock in XX Properties and become shareholders in the corporation immediately after the July 16, 2004, transfers; and the notices filed with the Department of Corporations support this inference by indicating that XX Properties issued 15,000 share of stock to M and S for \$150,000 of property other than money, which seems likely to be Lots 11 and 12. Furthermore, the facts do not support the inference that S intended to make a gift of Lot 12 to XX Properties or that he agreed to transfer Lot 12 to XX Properties and then wait two months to receive his voting stock, and they do not indicate that S received his voting stock as a gift from M. Therefore, it is reasonable to conclude that both M and S

became stockholders in XX Properties at the same time when they completed their agreement and transferred Lots 11 and 12 to XX Properties on July 16, 2004.

3. The Step Transaction Doctrine

Where a taxpayer embarks on a series of transactions (steps) that are in substance a single, unitary or indivisible transaction for the purpose of avoiding a change in ownership, county assessors may disregard the intermediary steps and only give credence to the completed transaction. (See Annot. 220.0666, C 3/8/90; see also Annot. 220.0667, C 4/5/88.) In such a case, the “substance of the transaction, rather than the form” will determine if a change in ownership has actually occurred. (*Shuwa Investment Corp. v. County of Los Angeles* (1991) 1 Cal.App.4th 1635.) However, the step transaction doctrine applies only when there are several steps in a transaction that successfully prevent a change in ownership from occurring, and the unnecessary steps need to be ignored so as to properly tax the substance of the transaction. Here, the step transaction doctrine does not apply since there are essentially two, simultaneous, one-step transactions at issue, which did result in changes in ownership (i.e., two, simultaneous, non-proportional transfers of real property to a newly formed corporation in exchange for stock), and not multi-step transactions, which resulted in the successful transfer of real property without causing changes in ownership that would have otherwise occurred if some of the steps were not utilized.

The views expressed in this letter are only advisory in nature. They represent the analysis of the Legal Department based on present law and the facts set forth herein. Therefore, they are not binding on any person or governmental entity.

Sincerely,

/s/ John Dickerson

John Dickerson
Tax Counsel

JD:pb

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Encl.

cc:

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