



STATE OF CALIFORNIA

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May 16, 2007

***Re: Parent-Child Exclusion***

Dear Mr. :

This is in response to your January 11, 2007 letter to Robert Lambert, Acting Assistant Chief Counsel, and subsequent telephone conversation with me on April 16, 2007, in which you requested an opinion as to whether a non-pro rata distribution of the trustor's residence from an irrevocable family trust to yourself and your sister Elizabeth, the trustor's natural children, results in a change in ownership. For the reasons set forth below, I conclude that the parent-child exclusion contained in Revenue and Taxation Code<sup>1</sup> section 63.1 will apply to a portion of the distribution so that no change in ownership will occur with regard to a portion of the transfer of the residence.

**Factual Background**

Decedent, trustor, established a revocable family trust (trust) that became irrevocable upon her death. The primary asset of the trust is the trustor's principal residence (residence) valued at \$782,500, although the trust also holds some cash. The cash consists of a \$5,200 savings account, \$12,000 of rent received, and \$388,000 in proceeds from a loan secured by the residence.

The trust instrument provides that \$60,000 is to be distributed to three of the trust's six beneficiaries, you, Elizabeth, and Karen, who are the trustor's natural children. The trust instrument also provides that the rest of the trust property is to be divided equally between the trustor's six children, which also include the trustor's three stepchildren. The facts provided do not indicate whether the trustee has authority to make non-pro rata distributions of trust property to the six beneficiaries. However, for purposes of this opinion, I shall assume that the trust instrument does not limit the trustee's authority to make non-pro rata distributions and adjust the beneficiaries' interests to account for differences in value pursuant to Probate Code section 16246.

<sup>1</sup> Subsequent section references are to the Revenue and Taxation Code, unless otherwise indicated.

You are the trustee of the trust and borrowed the \$388,000 in your capacity as trustee. You now propose to: (i) distribute \$20,000 to Elizabeth, Karen, and yourself to satisfy the \$60,000 gift; and (ii) distribute undivided interests in the residence, which is encumbered by the \$388,000 loan and has a net value of \$394,500, to Elizabeth and yourself, so that Karen makes a gift of her one-sixth interest in the residual gift to you and Elizabeth, and distribute \$123,283.33 in cash to each of the three stepchildren, to satisfy the residual gift.

Your letter asks whether you and Elizabeth can claim the parent-child exclusion with regard to any portion of the transfer of the residence.

### Law & Analysis

County assessors are required to determine a new base year value for property that changes ownership after the 1975 lien date. (Rev. & Tax. Code, § 110.1, subd. (a)(2).) A "change in ownership" is defined 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. (Rev. & Tax. Code, § 60.) Section 63.1, subdivision (a) excludes from the definition of change in ownership the transfer or purchase of a principal residence and the first million dollars of full cash value of all other real property between parents and their children. This includes transfers through the medium of an inter vivos trust like the trust discussed in your letter. The term children includes, but is not limited to, any child born of the parent or parents and any stepchild of the parent or parents while the relationship of stepparent and stepchild exists. (Rev. & Tax. Code, § 63.1, subdivision (c)(3).)

Since section 63.1 only applies to transfers of interests in trust property between parents and their children, determining the identity of the transferor of an interest in trust property is very important. In addition, application of section 63.1 is even more complicated when a trust has multiple beneficiaries.

For example, assume that trust A has four beneficiaries with equal interests and contains one parcel of real property worth \$400,000. If the trustee is required to make a pro rata distribution of the residence to the four beneficiaries, the trustee is legally required to distribute an undivided, one-fourth interest in the residence to each beneficiary, and these distributions will be viewed as transfers from the trustor of the trust to the beneficiaries for purposes of applying section 63.1. If, the trustee does not do this, and, instead distributes the entire residence to one beneficiary, the distribution will be viewed as if the trustee made distributions of undivided, one-fourth interests in the residence to each beneficiary as required, which will still be treated as transfers from the trustor of the trust to the beneficiaries, followed by transfers of three of the four beneficiaries' undivided interests in the residence to the remaining beneficiary, which will be treated as transfers between the beneficiaries for purposes of section 63.1. As such, a change in ownership can occur upon the distributions from the trust to the beneficiaries and the transfers between the beneficiaries, if an exclusion from change in ownership does not apply. However, if the trustee of trust A has discretion to make non-pro rata distributions of trust property, the trustee is not legally required to distribute equal interest in the residence to each beneficiary so long as the trustee adjusts the distributions that are made so that each beneficiary receives property of equal value. Therefore, the trustee could borrow \$300,000 via a loan secured by the

residence, distribute \$100,000 to three of the four beneficiaries, distribute the encumbered residence with a net value of \$100,000 to the fourth beneficiary, and still have the distributions treated as transfers from the trustor of the trust to the beneficiaries for purposes of applying section 63.1. (See Property Tax Annotations 625.0235 and 625.0235.005.)<sup>2</sup>

For purposes of this letter, I have assumed that you have authority to make non-pro rata distributions as trustee of the trust described in your letter. If this is the case, you are not required to distribute undivided interests in the residence to each of the trust's six beneficiaries so long as the actual distributions are adjusted to ensure that each beneficiary receives property of equal value. Therefore, you may borrow funds via a loan secured by the residence in your capacity as trustee and distribute interests in the residence to some beneficiaries and cash to other beneficiaries so long as each beneficiary receives property of equal value, and these distributions will be treated as transfers between the trustor of the trust and the beneficiaries for purposes of applying section 63.1. However, if you distribute more than a one-sixth share to any one of the six beneficiaries, the additional value will be treated as though it were received from the beneficiary or beneficiaries that received less than a one-sixth share for purposes of applying section 63.1. For example, if the trustee of the trust described in the prior paragraph borrowed \$290,000 secured by the \$400,000 residence and distributed the encumbered residence to beneficiary 1, \$90,000 to beneficiary 2, and \$100,000 to each of beneficiaries 3 and 4. The distributions would be viewed as distributions of property worth \$100,000 from the trustor to each beneficiary followed by a transfer of property worth \$10,000 from beneficiary 2 to beneficiary 1 for purposes of applying section 63.1. This is because beneficiary 2 was entitled to receive a one-fourth share worth \$100,000 like the other beneficiaries, but permitted \$10,000 worth of that share to be given to beneficiary 1.

The trust described in your letter has \$799,700 in net assets. It has a residence valued at \$782,500, subject to a \$388,000 secured loan, and another \$17,200 in cash. After distributing \$60,000 to Elizabeth, Karen, and yourself, the trust will only have \$739,700 in net assets, which must be divided equally among all six beneficiaries, including Karen. Therefore, to the extent that the trustee distributes one-sixth of \$739,700 (or \$123,283.33) in value to each of the six beneficiaries, the distributions will be treated as transfers between the trustor and the beneficiaries for purposes of applying section 63.1. To the extent that any beneficiary receives a distribution of more than \$123,283.33 in value the excess will be treated as a transfer between the beneficiaries as explained above.

Based upon the facts presented above, both Elizabeth and you will receive an undivided, one-half interest in the encumbered residence with a net value of \$197,250, and the three stepchildren will each receive \$123,283.33 in cash. Therefore, the percentage ownership interest in the property represented by \$123,283.33 of value of the distributions to Elizabeth and you will qualify for the parent-child exclusion provided by section 63.1 because this portion will be treated as though it were transferred from the trustor to her natural children. However, the excess distributions will be treated as though they were distributed to Karen, who did not receive a distribution of one-sixth of the \$739,700 net value of the trust property as required by the trust

<sup>2</sup> Property tax annotations are summaries of the conclusions reached in selected legal rulings of State Board of Equalization 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.)

instrument, and then transferred from Karen to Elizabeth and you. Therefore, the parent-child exclusion will not apply to the percentage ownership interest in the property in excess of your pro rata interest because it was received as a result of a transfer between siblings, not a transfer from a parent to her children, and thus will be subject to reassessment.

The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity. However, please feel free to contact me if you have further questions about this opinion.

Sincerely,

*/s/ Mariam Baxley*

Mariam Baxley  
Tax Counsel

MB:ad  
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cc: Honorable  
County Assessor

Mr. David Gau	MIC:63
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70