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July 9, 2019

This is in response to your letter dated May 31, 2019, regarding the parent-child change in ownership exclusion. In your letter, you pose the following three questions regarding the use of a third party loan to equalize a trust distribution:

1. If a step transaction is used to gain financing for the trust, can the acquiring beneficiary be the borrower?
2. If the acquiring beneficiary is the trustee, does some other 3<sup>rd</sup> party need to sign the loan documents and take responsibility for repayment?
3. Can the step transaction strategy be used to circumvent Annotation 625.0235.005? Is the acquiring beneficiary allowed to be the one to contribute funds, personally guaranteeing the loan or actually act as the borrower on the loan?

Section 2 of article XIII A of the California Constitution requires the reassessment of real property upon a "change in ownership," unless an exclusion applies. Revenue and Taxation Code (RTC) 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. RTC section 63.1 excludes from change in ownership transfers of real property between parents and children that meet certain criteria.

Section 63.1(c)(9) defines "transfer" to include "any transfer of the present beneficial ownership of property from an eligible transferor to an eligible transferee through the medium of an inter vivos or testamentary trust." Therefore, if a transfer of real property from a trust to the children of the trustor qualifies as a transfer from the trustor (i.e., the eligible transferor) to the transferee(s) pursuant to the terms of the trust, then the transfer is a transfer between parent(s) and child(ren), and, assuming all other conditions are met, qualifies for the parent-child exclusion.

The Board of Equalization (BOE) has opined that when a parent transfers property to a trust which provides that the children are to receive the trust assets on a share and share alike basis, unless the trust instrument specifies otherwise, the trustee has the power to distribute the property on a pro

rata or non-pro rata basis.<sup>1</sup> A trustee with the power to distribute the trust property on a non-pro rata basis may allocate specific assets to individual beneficiaries, so long as the value of their shares are equal. Thus, the transfer of an undivided interest in real property is considered a direct transfer from a trustor-parent to a beneficiary-child to the extent that the value of the property interest does not exceed the value of the beneficiary's proportionate share of the trust estate and, thus, may qualify for the parent-child exclusion under section 63.1. However, to the extent the value of the asset exceeds the value of that child's proportionate interest in the total trust estate, such excess must be considered a non-excludable transfer from the other beneficiaries akin to a sale of their interests to the recipient.

The BOE further opined in Annotation 625.0235.005 that a trustee who elects to make a non-pro rata distribution of trust real property to one beneficiary may equalize the value of the other beneficiaries' interests in the trust assets by encumbering the real property with a loan and distributing the loan proceeds to the other beneficiaries. However, a loan made by the recipient of the real property rather than the trustee in order to equalize the trust interests is considered payment for the other beneficiaries' interests in the real property resulting in a transfer between beneficiaries. In such event, the parent-child exclusion does not apply to the interests transferred between beneficiaries.

In your first question, you ask whether the acquiring beneficiary can be the borrower if a step transaction is used to gain financing for the trust. It is unclear what you mean by "step transaction." If you are referring to transfers of bare legal title from and back to the trust for the purpose of creating, assigning, or reconveying a security interest that is not coupled with the right to immediate use, occupancy, possession or profits (see Property Tax Rule 462.240(a)(2)), the trustee must be the person encumbering the property on behalf of the trust. The beneficiary who will receive the real property via distribution of trust assets cannot be the person encumbering the property.

In your second question, you ask if a third party must sign the loan documents and take responsibility for the payment if the acquiring beneficiary is the trustee. If the trustee is the beneficiary acquiring the real property, any loan on behalf of the trust must be done by the trustee as trustee, not as an individual. The trustee is the only one who is authorized to act on behalf of the trust. Loan proceeds should go to the trust, not to the beneficiaries. The goal is for the trust to get liquid assets, in addition to the real property, that can be distributed. If the lending company makes the checks directly to the beneficiaries, this would not be considered to be a distribution of trust assets, as the funds were not in the trust.

In your third question, you ask whether the step transaction strategy could be used to circumvent Annotation 625.0235.005, meaning whether the acquiring beneficiary would be allowed to be the one to contribute funds, personally guarantee the loan, or actually act as the borrower on the loan. The acquiring beneficiary would not be allowed to contribute funds, personally guarantee the loan, or act as the borrower on the loan for purposes of qualifying for the parent-child exclusion. Serving as a guarantor of a loan is similar to providing the loan proceeds, because a guarantor is liable for repayment if the trustee fails to make the loan payments. A loan guaranteed or made by the

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<sup>1</sup> Letter To Assessors No. 91/08 and Property Tax Annotation (Annotation) 625.0235.

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beneficiary receiving the property would be considered payment for the other beneficiaries' interests and would result in a partial reassessment.

We hope this information is helpful to you. If you have any further questions, please contact the County-Assessed Properties Division at 1-916-274-3350.

Sincerely,



David Yeung  
Deputy Director  
Property Tax Department

DY:gs

cc: Honorable Leslie Davis, President  
California Assessors' Association  
Mr. Henry Nanjo, Chief Counsel  
State Board of Equalization  
Ms. Lisa Thompson, Taxpayers' Rights Advocate  
State Board of Equalization