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UNDERSTANDING PROPERTY TAX TREATMENT OF TRUSTS

*by Wayne H. Gilbert and Timothy S. Galusha***

California taxes real property at a rate equal to 1 percent of a property's *assessed value,* plus any local or ad valorem taxes.[1] Prior to the passage of Proposition 13, the assessed value was equal to a property's current fair market value, and the fair market value was reassessed each year. Market values rose dramatically in the 1970s, and in response voters passed Proposition 13 to reign in rising property taxes. In 1978, Proposition 13 turned back assessed values to their March 1, 1975 levels and limited the annual increases. A property's assessed value is now equal to the fair market value of the property on the date there is a change in ownership, plus an annual inflation adjustment that may not exceed 2 percent of the prior year's assessed value, until a change in ownership or other event triggers a reassessment.[2]

During the nearly 30 years since Proposition 13 was enacted, property values generally have increased by far more than the 2 percent maximum annual increase in assessed values permitted under Proposition 13. As a result, the disparity between fair market value and assessed value of property has widened and the consequences of triggering a property tax reassessment has increased significantly. A family's ability to hold on to property passed from one generation to the next often hinges on whether a reassessment can be avoided. Understanding the change in ownership rules is important for every estate planner.

This article examines the change in ownership rules specifically affecting trusts. The change in ownership rules for trusts are based in part on statutes, property tax rules, and court cases, but many of the rules discussed in this article are based on opinions of the State Board of Equalization (the "SBOE").[3] It is important to be aware that, although county assessors look to the SBOE for guidance, county assessors are not bound by a position taken by the SBOE. County assessors may disagree with the SBOE's interpretation of a statute or regulation and may challenge an SBOE interpretation in court.

This article focuses on the change in ownership rules affecting trusts. Practitioners are cautioned that there are change in ownership rules addressing other forms of property ownership, including tenancies in common, joint tenancies, life estates, estates for years, leases, and legal entities, and that those rules must be considered in appropriate circumstances.

I. TRANSFER OF A PRESENT INTEREST

Revenue and Taxation Code section 60[4] 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.[5]

Generally, a person holding a present interest in real property has the right to the current use of, or current income from, the property. A present interest in real property may transfer from one person to another upon (i) a transfer of property to or from a trust, or (ii) a change in the present beneficiary of a trust.

II. IDENTIFYING THE TRANSFEROR AND TRANSFEREE

In analyzing each transfer, it is necessary to determine who is treated as transferring a present interest in property (the "transferor") and who is treated as receiving that present interest (the "transferee"). Whether a particular transfer to or from a trust, or a change in trust beneficiaries, is a change in ownership depends on the identity of the transferor and transferee. Ascertaining the parties involved is not always simple.

A. Transferor

1. *Transfer into Trust*

When the settlor contributes property to an irrevocable trust or when a revocable trust becomes irrevocable, the settlor is considered the transferor.[6] Trustees, holding legal title to property but no beneficial interest, are not considered transferors or transferees.[7]

2. *Transfer from Trust or Change in Beneficiary*

With one exception involving a general power of appointment (discussed in part IV), the SBOE takes the position that when the interest of one trust beneficiary terminates and the trust property is distributed to (or retained in trust for) another beneficiary, the settlor continues to be considered the transferor.[8]

Example. Settlor transfers property in trust for benefit of Daughter for life, remainder to Daughter's children. Upon death of Daughter, there is a transfer from Settlor to Daughter's children (rather than a transfer from Daughter to her children). Unless the requirements of the grandparent-grandchild exclusion (described in part III) are satisfied, there will be a change in ownership and reassessment on Daughter's death.

B. Transferee is Current Beneficiary

When property is transferred into an irrevocable trust, when a revocable trust becomes irrevocable, or when the interest of one trust beneficiary terminates and the trust property is retained in trust for another trust beneficiary, the current beneficiary of the trust is considered the transferee.[9] Beneficiaries holding future interests are ignored until their future interests become current interests.[10]

III. GENERAL TRUST RULE AND EXCLUSIONS

A change in ownership will occur upon (i) the conveyance of property to or from a trust, or (ii) a change in the present beneficiary of a trust, unless an exclusion applies.[11] The exclusions are the subject of this part III.

A. Revocable Trust

The transfer of real property to a *revocable* trust or a change in the present beneficiary of a revocable trust is not a change in ownership because no present interest is transferred. If a revocable trust becomes irrevocable, a change in ownership occurs and any real property held by the trust will be reappraised as of the date the trust becomes irrevocable, unless an exclusion applies.[12]

B. Proportional Interest Exclusion

If property is transferred to or from an irrevocable trust, and the proportional interests of the beneficial owners of the property remain the same before and after the transfer, there is no change in ownership.[13] Throughout the rest of this article, each trust will be assumed to be irrevocable, unless specifically designated as revocable.

Example. Property is held in Trust with A and B as equal beneficiaries. Trust terminates and Property transfers to A and B as tenants in common, each holding a 50 percent interest in Property. There is no change in ownership.

C. Reversionary Interest Exclusion

If property is transferred to a trust and the transferor retains a reversionary interest that will take effect in 12 years or less, there is no change in ownership.[14]

D. Transfer Between Trusts Exclusion

A transfer from one trust to another trust is not a change in ownership if the transfer qualifies as one of the other exclusions from the change in ownership rules.[15]

E. Beneficiary Qualifies for Exclusion

Property transferred *to* a trust will not constitute a change in ownership if a direct transfer of that property from the transferor to the present beneficiary of that trust would qualify for an exclusion.[16] Similarly, property transferred *from* a trust will not constitute a change in ownership if a direct transfer of that property from the transferor to the recipient would qualify for an exclusion.[17] Finally, a change in the present beneficiary of a trust will not constitute a change in ownership if a direct transfer of the property from the transferor to the new beneficiary would qualify for an exclusion.[18] The following is a brief summary of the rules concerning qualifying and non-qualifying beneficiaries:

1. *Identifying the Potentially Qualifying Trust Beneficiaries*

Beneficiaries who potentially qualify for an exclusion include the transferor and the transferor's spouse, registered domestic partner, child, parent, and grandchild.

a. Transferor

If the transferor is also the transferee, there is no change in ownership.[19]

b. Transferor's Spouse

The interspousal exclusion provides that a transfer from the transferor to the transferor's spouse is not a change in ownership.[20]

c. Transferor's Registered Domestic Partner

A transfer to the registered domestic partner of the transferor is not a change in ownership.[21]

d. Transferor's Child (or Parent)

Under the parent-child exclusion, a parent may transfer to his or her children without a change in ownership the parent's principal residence and up to $1 million of the full cash value of real property *other* than the principal residence.[22]

(i) For the parent-child exclusion, the following definitions are crucial:

(A) A "transfer" may be from parent to child or from child to parent.[23]

(B) "Child" includes a natural child (unless adopted by someone else while under 18 years old), an adopted child (if under 18 years old when adopted), a stepchild, and a spouse of any such person. In the case of any relationship based on marriage, the parent-child relationship will terminate if the marriage terminates by divorce, but if the marriage terminates by death, the parent-child relationship does not terminate until the in-law or stepparent remarries.[24]

Example: Father's son ("Son") marries Daughter-in-law. Daughter-in-law qualifies as father's "child" (a) so long as she is married to Son, and (b) after Son's death so long as Daughter-in-law remains unmarried. The "child" relationship ends when widowed Daughter-in-law remarries. The "child" relationship also ends if a Son and Daughter-in-law divorce.

(C) "Full Cash Value" is the assessed value of the property immediately before the transfer.[25]

(ii) Each parent is entitled to a $1 million parent-child exclusion. It is the SBOE's opinion that children may claim an exclusion from the first parent after the second parent dies if the property interest of the first parent to die was held in trust for the surviving parent for life, with remainder to children, as in the following example.[26]

Example. Husband dies in 1985 leaving property to an irrevocable trust in which Wife is the sole income beneficiary for life and has the power to invade the principal for reasonable health, education, and support. Their children hold the remainder interests. Upon Wife's death in 1995, the children can claim a $1 million exclusion from Husband.[27]

Comment. The SBOE opinion applies even in situations (as in example above) where the first parent died prior to the enactment of the parent-child exclusion in 1986. Also, although the SBOE example concerns only transfers occurring at death, the same analysis should apply to comparable transfers made during lifetime.

e. Transferor's Grandchild.

Under the grandparent-grandchild exclusion, a grandparent may transfer property to a grandchild on terms similar to those allowed in transfers qualifying for parent-child exclusion.[28] Because the grandparent-grandchild exclusion can be quite important where property is owned by an irrevocable trust, this article will discuss the limitations of the grandparent-grandchild exclusion in some detail.

(i) All Parents Must be Deceased.

In general, the grandparent-grandchild exclusion applies only if *all* parents of the grandchild who qualify as children of the grandparent are deceased.[29] Under a recent amendment to section 63.1(a)(3)(A), a son-in-law or daughter-in-law who is a stepparent (rather than a natural parent) of a grandchild does not need to be deceased.[30]

Authors have advised this should read "there is no change in ownership"

Example One. Transferor's family consists of Son, Daughter-in-law, and Grandchild (who is the child of Son and Daughter-in-law). Son dies before Transferor. On Transferor's death, Transferor leaves property in trust for benefit of Grandchild. If Daughter-in-law is alive and has not remarried, there will be a change in ownership on Transferor's death. The transfer to Grandchild is not excluded because Daughter-in-law is considered a child of Transferor. By contrast, if Daughter-in-law is alive but has remarried, there is change in ownership because Daughter-in-law is no longer considered a child of Transferor.

Example Two. Same as in prior example, except Daughter-in-law is not Grandchild's mother. The transfer to Grandchild qualifies for the grandparent-grandchild exclusion, assuming ~~the birth mother is deceased and~~ the other requirements are satisfied. Although Daughter-in-law is treated as Transferor's child, she does not have to be deceased in order for the grandparent-grandchild exclusion to be available.

Authors have advised "the birth mother is deceased and" should be stricken inasmuch as she has divorced Son and it does not matter whether she is alive or not.

Example Three. Transferor's family consists of Son, Daughter-in-law, and Grandchild (who is the child of Son and Daughter-in-law). Transferor transfers property in trust for benefit of Son for life, remainder to Grandchild. Upon Son's death, there is a transfer from Transferor to Grandchild (rather than a transfer from Son to his child). If Daughter-in-law survives Son and was married to him at the time of his death, there will be a change in ownership on Son's death. The transfer to Grandchild is not excluded because Daughter-in-law is considered a child of Transferor. A change in ownership could be avoided if the trust provides that on the Son's death, the property will continue to be held in trust for Daughter-in-law for her life or until she remarries (assuming the transfer to Daughter-in-law qualifies for the parent-child exclusion),[31] remainder to Grandchild.

(ii) Additional Requirements for Exclusion.

As with the parent-child exclusion, property potentially qualifying for the grandparent-grandchild exclusion includes the grandparent's principal residence and up to $1 million of full cash value of other property.[32]

(A) One Million Dollars Per Transferor. Each transferor is allowed only a single $1 million exclusion for transfers to children and grandchildren. Thus, the $1 million exclusion is unavailable for transfers to grandchildren to the extent it has previously been used in connection with transfers to children.

(B) Grandchild May Receive Only One Residence. If a grandchild has received any interest in a principal residence in a transaction for which the parent-child exclusion was claimed, a transfer of a grandparent's principal residence to a grandchild does not qualify for the exclusion as a principal residence, but may qualify for the $1 million exclusion.[33]

(C) Certain Transfers Charged Against $1 Million Exclusion. The $1 million exclusion available to transfers from a grandparent to a grandchild is reduced by the full cash value of (i) any property transferred to a grandchild in a transaction that qualified for the $1 million parent-child exclusion, and (ii) a grandparent's principal residence transferred to a grandchild that did not qualify as the transfer of a principal residence.[34]

Example One. Transferor's family consists of Son, Daughter, and Grandchild, who is Daughter's child. Daughter is divorced from Grandchild's father. Transferor transfers an office building with an assessed value of $1 million to Son and Daughter. The parent-child exclusion is claimed. Daughter dies, leaving her principal residence with an assessed value of $250,000 to Grandchild. The parent-child exclusion is claimed. Transferor subsequently transfers his principal residence with an assessed value of $500,000 to Grandchild. No exclusion is available for the transfer of Transferor's principal residence to Grandchild. The transfer cannot be excluded as Transferor's principal residence because Grandchild has received Daughter's principal residence and Transferor's $1 million exclusion has been fully used in connection with the transfer of the office building to Son and Daughter.

Example Two. Transferor's family consists of Son, Daughter, and Grandchild, who is Daughter's child. Daughter is divorced from Grandchild's father. Daughter dies, leaving an office building with an assessed value of $800,000 to Grandchild. The parent-child exclusion is claimed. Transferor, who has made no transfers charged against the $1 million exclusion, subsequently transfers a commercial property with an assessed value of $500,000 to Grandchild. The grandparent-grandchild exclusion is limited to $200,000 because the $800,000 transfer from Daughter to Grandchild reduces the $1 million exclusion available on the transfer from Transferor to Grandchild.

f. Eligibility of Settlor Who Never Owned Property.

The SBOE appears to have conflicting opinions as to whether a settlor is an "eligible transferor" for purposes of the parent-child exclusion or grandparent-grandchild exclusion if the settlor never owns any interest in the property being transferred.

Example. Upon Settlor's death, Settlor's assets are transferred to a trust for the benefit of Husband for life, remainder to Daughter. After Settlor's death, trustee purchases property with trust assets. Upon Husband's death, the property is distributed to Daughter. Under the SBOE's position in a 1992 letter, Settlor is not an eligible transferor because Settlor never owned any interest in the property, and Husband is also not considered an eligible transferor, and therefore no parent-child exclusion may be claimed for the transfer to Daughter.[35] In contrast, the SBOE's opinion in a 1998 unannotated letter would treat the settlor as an eligible transferor of the property and allow the parent-child exclusion (assuming all other requirements of the parent-child exclusion are satisfied).[36] The 1998 letter does not provide any reason for its position.

2. Transfers to Trusts if All Beneficiaries Qualify

If property is transferred to a trust in which all the beneficiaries qualify for an exclusion, there is no reassessment.[37]

Example. Upon Transferor's death, property is transferred to a trust for the benefit of Wife and Child equally. There is no change in ownership if the interest passing to Child qualifies for the parent-child exclusion.

3. Transfers to Trusts if Some Beneficiaries are Non-qualifying and Trustee Lacks Discretion

If the trustee has no discretion as to who receives the beneficial interest, and there are beneficiaries who do not qualify for an exclusion, only the portion held for non-qualifying beneficiaries is reassessed.[38]

Example. Upon Transferor's death, property is transferred to a trust for the benefit of Wife, Child, and Niece. The trust instrument provides that all distributions must be made to the three beneficiaries in equal shares. The interests in the property passing to Wife and Child may qualify for the interspousal and parent-child exclusions, but the one-third interest in the property passing to niece does not qualify for any exclusion and is reassessed.

4. Transfers to Trusts if Some Beneficiaries are Non-qualifying and Trustee Has "Sprinkle Power"

If the trustee has total discretion as to who receives the beneficial interest (i.e., a "sprinkle power"), and the beneficiaries include non-qualifying beneficiaries, then 100 percent of the property is reassessed.[39] The result is the same where the trustee's discretion to distribute among qualifying and non-qualifying beneficiaries is limited by an ascertainable standard, such as health, education, support, or maintenance.[40]

Example. Upon Transferor's death, property is transferred to a bypass trust whose terms authorize the trustee to make distributions to Wife, Child, and Child's descendants in amounts the trustee deems appropriate for any reasonable purpose. If Child is living and has descendants, the property will be reassessed because the trustee could pass all of the beneficial interest to Child's descendants, who do not qualify for any exclusion.

A "sprinkle power" will not result in a change in ownership if each current beneficiary qualifies for an exclusion.[41] Thus, in the example above there would have been no change in ownership if the sprinkle power was limited to Wife and Child and the requirements of the parent-child exclusion were satisfied.

a. Claiming Parent-Child Exclusion

If the trustee has a sprinkle power to distribute among a spouse and children only, there will be no change in ownership to the extent the interest passing to the children qualifies for the parent-child exclusion and a Claim for Reassessment Exclusion form is timely filed.[42] According to counsel for the SBOE, the children must assume for purposes of filing the claim form that they are receiving 100 percent of the property.

Example. Upon Transferor's death, property (other than Transferor's principal residence) with an assessed value of $1 million is transferred to a trust for benefit of Wife and Child, and the trustee has a sprinkle power. No part of Transferor's $1 million exclusion has previously been used. Child must claim the $1 million exclusion to avoid a change in ownership. If the assessed value were $10 million, there would be a reassessment of the 90 percent interest in the property that does not qualify for an exclusion.

b. Disclaimer

According to the SBOE, if property is transferred to a sprinkling trust that includes both qualifying and non-qualifying beneficiaries, a change in ownership can be avoided if the non-qualifying beneficiaries disclaim their interests.[43] A disclaimer is not treated as changing the Transferor. As a result, a disclaimed interest is deemed to pass from the transferor, and not from the person disclaiming the interest.[44]

5. *Interests of Non-Qualifying Beneficiaries Ignored Where Qualifying Beneficiaries Entitled to All Income.*

The SBOE has taken the position that where a surviving spouse is entitled to receive all trust income, and the trustee has the power to invade trust principal for the benefit of the spouse and others (e.g., for the health, support, and maintenance of the spouse and children), the spouse is the sole present beneficiary and the other beneficiaries are treated as holding only future interests. The SBOE distinguishes this situation from a sprinkle power, where the trustee has discretion to make distributions to any of the current beneficiaries, but no beneficiary is entitled to receive distributions.[45]

The SBOE position that the interests of discretionary beneficiaries should be ignored where another beneficiary is entitled to all trust income presents a number of planning opportunities. In situations involving a surviving spouse and children, the SBOE position will eliminate the need to claim the parent-child exclusion when the property is transferred to the trust, permitting the $1 million exclusion to be used in connection with other property or avoiding a change in ownership where the $1 million exclusion was previously used. Moreover, there would appear to be no analytical basis for limiting the SBOE's conclusion that a beneficiary entitled to all trust income is treated as the sole present beneficiary to situations involving a spouse and children and at least one SBOE opinion appears to apply a similar analysis to treat the transferor's children as the sole present beneficiaries of a trust.[46] Thus, it should be possible to avoid a change in ownership where property is transferred to a trust in which a beneficiary who qualifies for an exclusion is entitled to all trust income and the trustee has discretion to distribute principal to non-qualifying beneficiaries.

Example. Settlor transfers property to a trust, with income to Child for life. Trustee is given power to invade principal for the health, education, support, or maintenance of Child and Child's descendants. Based on the SBOE analysis in the opinions involving a surviving spouse and children, Child should be treated as the sole present beneficiary and Child's descendants should be treated as holding future interests. Under this analysis, the transfer of the property to the trust would not trigger a reassessment as long as the transfer qualifies for the parent-child exclusion. By entitling Child to all trust income, it is possible to transfer property to a trust that authorizes the trustee to make principal distributions to Child's children and more remote descendants, without the transfer triggering a reassessment. In contrast, if the trustee had the power to sprinkle income among Child and Child's descendants, the property would have been reassessed.

Note that the SBOE opinions do not address the consequences if the trustee makes a principal distribution to a beneficiary other than the one entitled to receive the trust income. Presumably, any portion of the property transferred in such a distribution would be reassessed unless that transfer qualifies for an exclusion.

6. *Birth or Death of Present Beneficiary*

Several SBOE opinions have considered whether the birth of a new present beneficiary or the death of an existing present beneficiary triggers a change in ownership in property held by a trust for the benefit of multiple present beneficiaries. The opinions are somewhat confusing, as described below.

a. Change in Ownership on Death of Beneficiary Where Interests are Fixed.

For property held in a trust where the trustee was required to distribute income in equal shares to the beneficiaries, a 1999 SBOE opinion took the position that the death of a beneficiary triggered a change in ownership, unless an exclusion applied.[47]

Example. Parent transfers property to a trust for the benefit of Parent's five sons in equal shares. The trust instrument provides that a son's interest in the trust terminates on death, and the income is reallocated among the surviving sons. According to the SBOE, the death of each son constitutes a change in ownership as to the interest that is reallocated to the surviving beneficiaries. According to the SBOE, the death of each son constitutes a change in ownership as to the interest that is reallocated to the surviving beneficiaries, except to the extent a parent-child exclusion applies.

b. No Change in Ownership on Death of Beneficiary of Sprinkling Trust.

In a 2001 letter, the SBOE took the position that for property held by a sprinkling trust, the death of one beneficiary does not constitute a change in ownership.[48]

Example. Parents create irrevocable trust whose present beneficiaries are parents' four children. The trustee is required to distribute all income to any one or more of the beneficiaries and has discretion to distribute principal to any one or more of the present beneficiaries. The trust instrument provides that when a child dies, the child's interest in the trust terminates, and the income and principal may then be sprinkled among the surviving children. The SBOE held that the death of a child does not constitute a change in ownership, and the surviving children do not have to rely upon an exclusion. The 2001 letter took the position that the interest of a current beneficiary in a sprinkling trust does not change on the death of another current beneficiary.

c. Change in Ownership on Birth or Death of Beneficiary in Sprinkle Power Trust.

In a letter issued in 2006, the SBOE concluded that there is a change in ownership for property held by a trust with a sprinkle power if, by reason of a birth or death, the trust adds or loses a beneficiary. However, the SBOE indicated that there will not be a change in ownership if (1) upon the *death* of a beneficiary, all remaining beneficiaries qualify for an exclusion, or (2) upon the *birth* of a beneficiary, the new beneficiary qualifies for an exclusion. In addition, if no exclusion is available, the entire property is not necessarily reassessed. The SBOE stated that only a partial interest is reassessed based on the assumption that all potential beneficiaries are granted an equal interest in the property (relying in part on Probate Code section 245).[49]

Example. Upon Transferor's death, property is transferred to a "sprinkling trust" for benefit of Transferor's descendants. At the time of Transferor's death, she has four children and no other descendants. Five years after Transferor's death, Grandchild (who is Transferor's fifth descendant) is born. Twenty percent of property will be reassessed.

d. Opinions Difficult to Reconcile.

The SBOE opinion letters appear to provide conflicting answers that the authors find difficult to reconcile. The 1999 and 2001 letters might be distinguished based on the terms of the trust instruments: the trust in the 1999 letter fixed the interests of the beneficiaries and the trust in the 2001 letter granted the trustee power to sprinkle interests among the beneficiaries. However, the 2006 letter also involved a sprinkling trust and reached the opposite conclusion than the 2001 letter.

The 2006 letter held that the birth or death of a beneficiary did trigger a change in ownership, although the 2006 letter limits the impact of its decision by holding that birth of a non-qualifying beneficiary triggers *only* a partial reassessment. A partial reassessment seems inconsistent with the SBOE's position that there is a full reassessment upon the transfer of property to a sprinkling trust with a non-qualifying beneficiary. However, the SBOE's position in the 2006 letter avoids the draconian result of having each birth of a non-qualifying beneficiary trigger a 100 percent reassessment.

One possible explanation of the differing conclusions reached in the 2001 and 2006 letters is that the 2001 letter involved children, who are potentially eligible for an exclusion as present beneficiaries, whereas the 2006 letter involved non-qualifying beneficiaries. However, the potential qualification of the beneficiaries involved is not addressed in either the 2001 or the 2006 letter, and it does not seem that the analysis should change based on the type of beneficiaries. Another possible explanation of the differing conclusions is that the property involved in the 2001 letter was reassessed when it was purchased by the trust, while the property involved in the 2006 letter had been acquired by the trust before the passage of Proposition 13 and had not been reassessed. However, neither opinion focuses on this distinction and there would appear to be no analytical basis for treating the birth or death of a beneficiary differently depending on whether there is a change in ownership when property is acquired by a trust.

IV. POWERS OF APPOINTMENT

The statutes and rules are silent concerning the treatment of powers of appointment for change in ownership purposes and no reported decision has considered this issue. As a result, the limited guidance that is available concerning the property tax consequences of powers of appointment is in the form of SBOE opinions.

A. Holder of General Power of Appointment Becomes Transferor of Trust Property

The SBOE takes the position that the holder of a general power of appointment (rather than the settlor) is treated as the transferor for purposes of determining whether there is a change in ownership.[50] This position is based on court decisions treating a grant of a general power of appointment as equivalent to a grant of absolute ownership.[51] According to the SBOE, the holder of a general power of appointment is treated as the transferor regardless of whether the property passes to one or more appointees as a result of the exercise of the power or the property passes to one or more takers in default as a result of the non-exercise of the power.[52]

Example. Settlor transfers property in trust for the benefit of Daughter for life and provides Daughter with a testamentary general power of appointment. Daughter exercises her power of appointment in favor of (her) Husband and Child in equal shares. Because Daughter holds a testamentary general power of appointment, at Daughter's death there is a transfer from Daughter to Husband and Child (rather than a transfer from Settlor to Husband and Child). The result is the same if Husband and Child receive property on Daughter's death as a result of the non-exercise of Daughter's testamentary general power of appointment. The transfer to Husband qualifies for the interspousal exclusion and the transfer to Child will qualify for the parent-child exclusion if all the other conditions of the parent-child exclusion are satisfied.

The SBOE takes the position that a trust beneficiary with a "five and five" power (i.e., a non-cumulative power to withdraw the greater of $5,000 or 5 percent of the value of the trust assets each year) will be treated as the transferor with respect to an increasing fraction of the trust assets.[53] According to the SBOE, the portion of the trust with respect to which the "five and five" power beneficiary is the transferor is determined by multiplying 5 percent by the number of years in which the power was exercisable. As a result, the holder of a "five and five" power will become the transferor with respect to the entire trust when the power becomes exercisable in the 20th year.[54] Note that according to the SBOE, the holder of a lapsed withdrawal power continues to be treated as the transferor over the portion of the property that was subject to the withdrawal power before the lapse.[55] Although the SBOE opinion dealt only with "five and five" powers, it should be equally applicable to other withdrawal powers, including *Crummey* powers.

The SBOE position regarding the treatment of withdrawal powers opens the following planning opportunity. A trust beneficiary may be given the right to withdraw all assets of a trust, with that power lapsing by 5 percent each year. The beneficiary would be treated as the transferor of the entire trust for property tax purposes. However, after 20 years the withdrawal power will have fully lapsed and no portion of the trust property will be included in the beneficiary's gross estate for federal estate tax purposes.[56]

B. Holder of Limited Power of Appointment Does Not Become Transferor of Trust Property

The grant of a limited power of appointment is generally *not* treated as the equivalent to a grant of absolute ownership. In most opinions considering limited powers of appointment, the SBOE has concluded that when a trust beneficiary exercises, or fails to exercise,[57] a limited power of appointment, the settlor remains the transferor for purposes of determining whether there is a change in ownership.[58]

Example. Settlor transfers property in trust for the benefit of Daughter for life and provides Daughter with a *testamentary* limited power of appointment exercisable in favor of her spouse and descendants. Daughter exercises her power of appointment in favor of Husband and Child in equal shares. Because Daughter holds only a limited power of appointment, Settlor remains the transferor. As a result, the transfer to Husband will qualify for the parent-child exclusion if all other conditions of the parent-child exclusion are satisfied. Whether the transfer to Child (Settlor's grandchild) qualifies for the grandparent-grandchild exclusion (assuming other requirements are satisfied) depends on whether Husband is Child's father. If Husband is Child's father, no exclusion is available and the interest in the property transferred to Child will be reassessed. If Husband is not Child's father, the transfer to Child will qualify for the grandparent-grandchild exclusion if the other requirements are satisfied.

C. Permissible Appointee has Future Interest

A permissible appointee who could receive an interest in property upon the *exercise* of a power of appointment is not treated as a present beneficiary. The SBOE characterizes the interest of a permissible appointee as a future interest and holds that as a "general rule" the existence of a power of appointment does not effect the determination of who qualifies as a present beneficiary.[59]

Example. Surviving Spouse with Inter Vivos Power of Appointment over Bypass Trust. On Husband's death, property is transferred to a bypass trust for the benefit of Wife. Wife is entitled to receive distributions of income and principal for her health, education, support, and maintenance and has a limited inter vivos power of appointment exercisable in favor of Husband and Wife's descendants, who include children and grandchildren. The SBOE takes the position that Wife is the sole present beneficiary of the bypass trust and that the interests of the children and grandchildren as permissible appointees are future interests. As a result, the transfer of the property to the bypass trust qualifies for the interspousal exclusion and the property will not be reassessed.[60]

D. Sprinkle Power, All Income Trust, and Inter Vivos Power of Appointment Compared

As noted above, where property is transferred to a bypass trust whose terms permit the trustee to make distributions among a class of beneficiaries including at least one beneficiary who does not qualify for an exclusion (e.g., a grandchild with two living parents), the property will be reassessed. In contrast, there will *not* be a reassessment where property is transferred to a bypass trust requiring all income to be distributed to the transferor's spouse, but authorizing principal distributions to be made under an ascertainable standard to a class of beneficiaries including at least one beneficiary who does not qualify for an exclusion. Similarly, there will *not* be a reassessment where property is transferred to a bypass trust authorizing distributions of income and principal to be made to the transferor's spouse under an ascertainable standard and providing the spouse with a limited inter vivos power of appointment exercisable in favor a class of beneficiaries, at least one of whom does not qualify for an exclusion. A practitioner choosing between these two alternative methods of permitting distributions to be made from a bypass trust to beneficiaries who do not qualify for an exclusion without causing a reassessment should focus on the following two factors. First, is it appropriate under the circumstances to require all income of the bypass trust to be distributed to the surviving spouse? Second, should decisions regarding whether and to what extent there will be distributions to beneficiaries other than the surviving spouse be made by a trustee subject to fiduciary duties or by the surviving spouse under a power of appointment exercisable in a non-fiduciary capacity?

Although the relevant SBOE opinions deal with trusts for the benefit of the transferor's spouse, it should be possible to use either of the two techniques described in the preceding paragraph to transfer property to a trust for the benefit of a child and the child's descendants without a change in ownership. Thus, a trust instrument might provide that trust income must be distributed to the child and authorize principal distributions to the child's descendants under an ascertainable standard. Alternatively, a trust instrument might provide that income and principal distributions may be made to the child under an ascertainable standard, with the child holding a limited inter vivos power of appointment in favor of his or her descendants.

V. NON-PRORATA DISTRIBUTIONS OF PROPERTY

When parents die and leave real property to their children, it is not uncommon for one or more of the children to wish to continue holding the property, while other children wish to sell their interests. However, because no exclusion is available for transfers between siblings, any interest in property that is treated as being purchased by one child from another will be reassessed. Without careful planning, a non-prorata distribution of property may be treated as a deemed sale, triggering a partial reassessment. As described below, the SBOE has provided guidelines on how to accomplish a non-prorata distribution of property without triggering a change in ownership.[61]

A. Specifically Devised Property

If property is specifically devised in a trust to one or more beneficiaries and is distributed from the trust in a different manner (i.e., in different proportions or to different beneficiaries), there is a deemed transfer of any interest in the property that was distributed to a different recipient than was specified under the trust, resulting in a partial reassessment of the property.[62]

Example. Parent transfers property to a trust, which provides that the property is to be distributed equally to Son and Daughter on Parent's death. On distribution, however, Son receives the property and Daughter receives other trust assets of equal value. Daughter is deemed to have transferred a one-half interest in the property to Son. Because no exclusion applies to the deemed transfer, Daughter's one-half interest in the property is reassessed.

B. Property Not Specifically Devised

According to the SBOE, property that is not specifically devised under a trust may be allocated among beneficiaries without a deemed transfer occurring unless a beneficiary receives property with a value in excess of his or her share of the trust or the trust instrument prohibits the trustee from making non-prorata divisions of trust assets.[63]

Example One. Parent transfers property to a trust, which provides that the trust assets are to be distributed equally to Son and Daughter on Parent's death. At Parent's death, the trust assets consist of the property worth $500,000 and securities worth $500,000. If Son receives the property and Daughter receives the securities, there will be no deemed transfer from Daughter to Son and the parent-child exclusion may be claimed for 100 percent of the property, assuming the other requirements for the parent-child exclusion are satisfied.

Example Two. Same facts as in prior example except that the securities are worth only $400,000. Because Son is only entitled to receive a distribution of $450,000 but has received assets worth $500,000, there will be a deemed transfer from Daughter to Son of a one-tenth interest in the property, resulting in reassessment of that one-tenth interest.

C. How to Handle Real Property that Exceeds Value of Other Trust Assets

The SBOE has taken the position that where the value of the real property being distributed exceeds the beneficiary's share of the trust as in the example above, the fiduciary making the distribution may avoid reassessment by placing debt on the property to adjust the value of the assets distributed to the various beneficiaries.

1. Third Party Lender

The preferred method of encumbering the property is to have the trustee obtain a loan from a third party lender.

Example. Parent transfers property to a trust, which provides that the trust assets are to be distributed equally to Son and Daughter on Parent's death. At Parent's death, the trust assets consist of the property worth $500,000 and securities worth $400,000. Before distribution of the trust assets, the trustee borrows $50,000 from a bank, secured by a deed of trust against the property. On distribution, Son receives the property subject to the deed of trust and Daughter receives securities worth $400,000 and $50,000 cash for an equal division of the trust assets. Because each beneficiary has received his or her prorata share of the trust assets there is no change in ownership.[64]

2. *Alternative—Note and Deed of Trust from Beneficiary*

In practice, commercial lenders typically are unwilling to loan to a trustee under the circumstances in the example above. According to SBOE counsel, an alternative method of encumbering a property is to have the beneficiary receiving the property execute a note and deed of trust in favor of the trustee in exchange for the property.

Example. In the example above: (a) the trustee would distribute the property to Son in exchange for a promissory note in the amount of $50,000 secured by a deed of trust in favor of the trustee, and (b) the trustee would distribute the securities, note, and deed of trust to Daughter. After the distributions are made, Son would pay off the note.[65]

The SBOE's written memorandum describing the example above advises the taxpayer to make the note in favor of the party not receiving the property, however, SBOE counsel has suggested orally and via e-mail that the note should be made in favor of the trustee.[66] The authors recommend the latter approach so that the transaction involves the trust and is not between individual beneficiaries.

The form of the transaction is critical. The SBOE states that a loan made from the beneficiary to the trust prior to the distribution of the property would not avoid a change in ownership.[67] Thus, if in the above example Son gave trustee $50,000 rather than a promissory note, the SBOE would treat the transaction as a purchase by Son of Daughter's interest, triggering a reassessment.

VI. CONCLUSION

Estate planning attorneys must be aware of Proposition 13 concerns when drafting trust agreements and when handling the distribution of real property pursuant to the terms of a trust or will. Many commonly used drafting techniques result in unintended property tax consequences, often causing reassessments that could have been avoided by using alternative drafting techniques. To avoid such adverse consequences, it is essential for practitioners to have a thorough understanding of the change in ownership rules that apply to trusts.

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BOE later reversed its position on this strategy. See "Notation to Paragraph V.c.2. on P. 14" following this article.

As of 2011, the firm name is Thompson, Welch, Soroko & Gilbert LLP, Corte Madera, CA.

ENDNOTES

1. Cal. Const., art. XIIIA, §§ 1, 3.
2. The assessed value may also increase upon completion of new construction, and the assessed value may decrease if the property's value declines. This article considers only change in ownership issues.
3. Except as otherwise indicated, all code section references refer to the California Revenue and Taxation Code and all rule references refer to the Property Tax Rules (also referred to as Regulations) of the SBOE.
4. All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.
5. Rev. & Tax. Code, § 60.
6. *Allen v. Sutter County Bd. of Equalization* (1983) 139 Cal.App.3d 887, 890; see Letter to taxpayer dated February 29, 1988, Annotation No. 220.0790. Letter to taxpayer refers to an SBOE annotated opinion letter. SBOE letters to taxpayers, to specific county assessors, and to all county assessors (cited here as LTA's) may be found on the SBOE website at http://www.boe.ca.gov/proptaxes/proptax.htm.
7. *Allen v. Sutter County Bd. of Equalization* (1983) 139 Cal.App.3d 887, 890; see Letter to taxpayer dated February 29, 1988, Annotation No. 220.0790. Note that there is one situation in which a property interest is attributed to a trustee. The SBOE has taken the position that both a beneficiary *and a trustee* are deemed to have "control" of corporate stock held by a trust for purposes of determining whether any person or entity has acquired control under § 64(c). See Letter to taxpayer dated April 11, 1983, Annotation 220.0105 and Letter to taxpayer dated December 11, 1991, Annotation No. 220.0769.
8. Letter to San Joaquin County Assessor dated August 5, 1991, Annotation No. 220.0777.
9. *Allen v. Sutter County Bd. of Equalization* (1983) 139 Cal.App.3d 887, 890; see Letter to taxpayer dated February 29, 1988, Annotation No. 220.0790.
10. Letter to taxpayer dated August 30, 1985, Annotation No. 220.0810, Letter to taxpayer dated June 16, 1995, Annotation No. 220.0775, and Letter to taxpayer dated June 19, 1987, Annotation No. 220.0785.
11. Rule 462.160 and Rev. & Tax. Code, § 61(h) and § 62(d); *Reilly v. City & County of San Francisco* (2006) 142 Cal.App.4th 480.
12. Rev. & Tax. Code, § 61(h) and § 62(d); Rules 462.160(b)(2) and 462.260(d)(1).
13. Rule 462.160(b)(5), (d)(6); See also Rule 462.160(d)(1), which provides that when a trust transfers trust property to the beneficiary who was the current beneficial owner of the property prior to the transfer, there is no change in ownership. This rule does not appear to apply in any situation that is not also covered by the proportional interest exclusion.
14. 2. Rev. & Tax. Code, § 62(d); Rule 462.160(b)(1)(B).
15. Rule 462.160(b)(6).
16. The three statements of this paragraph that compare trust transfers to *direct* transfers of property represent the authors' synthesis of the change in ownership trust rules, and do not reflect concepts clearly stated in the statutes, rules, or SBOE opinions. Certain transfers made *to* trusts are specifically excluded under Rev. & Tax Code, § 62(d) and Rule 462.160(b); however, §62(d) and Rule 462.160(b) do not provide an exhaustive list of exclusions for transfers into a trust. For example, the domestic partner exclusion is not specifically referenced in the code section or the Rule, but section 62(p)(1) specifically excludes transfers to and from trusts made for the benefit of registered domestic partners.

17. Certain transfers made *from* trusts are specifically excluded under Rule 462.160(d); however, Rule 462.160(d) does not provide an exhaustive list of the possible exclusions for transfers from a trust.

18. See Letter to San Joaquin County Assessor dated August 5, 1991, Annotation No. 220.0777, for the SBOE analysis of a change in the present beneficiary.

19. Rule 462.160(b)(1)(A). Also, if an ownership interest in a legal entity that owns real property is transferred by a settlor into a trust in which the settlor (or settlor's spouse) is the sole beneficiary, the transfer does not constitute a change in ownership, regardless of the percentage ownership interest transferred. Rule 462.160(b)(1)(C). Note that this exclusion does not apply if the present beneficiary of the trust receiving the ownership interests is the settlor's child, grandchild, or any other beneficiary. However, transfers of entity interests to someone other than the settlor or settlor's spouse may not constitute a change in ownership under the change in ownership rules concerning legal entities. Rev. & Tax. Code, §§ 62(a), 64(c), 64(d).

20. Rev. & Tax. Code, § 63; Rule 462.160(b)(3), (d)(4). The interspousal exclusion applies to both transfers of real property and transfers of ownership interests in legal entities. This broad exclusion does not require the filing of a claim.

21. Rev. & Tax. Code, § 62(p). Note that this exclusion applies to transfers made on or after January 1, 2006. For transfers made before January 1, 2006, a more limited exclusion, applying only to transfers to a surviving registered domestic partner by intestate succession, is contained in Rule 462.240(k). The statutory language of the domestic partner exclusion under section 62(p) is nearly the same as that of the interspousal exclusion, but it is uncertain if domestic partners will receive identical treatment. The SBOE's analysis of section 62(p) in its November 1, 2005 Letter to Assessors notes the parallels to the interspousal transfers, and refers to the exclusion as "similar" to the interspousal transfer, but does not state that the exclusions are the same. The domestic partner exclusion is automatic and does not require a taxpayer to file a claim, however, taxpayers should inform the assessor of the domestic partner exclusion if the deed or other conveyance document does not identify the transfer as occurring between domestic partners.

22. Rev. & Tax. Code, § 63.1(a). Note that the parent-child exclusion does not apply to transfers of interests in legal entities under section 63.1(c)(8). The SBOE's April 22, 1998 Letter to County Assessors provides a thorough overview of the parent-child exclusion. LTA No. 1998/23.

23. Rev. & Tax. Code, § 63.1(c)(9).

24. Rev. & Tax. Code, § 63.1(c)(3).

25. Rev. & Tax. Code, §§ 63.1(c)(5), 110.1.

26. LTA No. 1998/23 dated April 22, 1998.

27. *Ibid.*

28. The grandparent-grandchild exclusion applies only to transfers from grandparents to grandchildren and not to transfers from grandchildren to grandparents. Rev. & Tax Code, § 63.1(c)(2). In contrast, the parent-child exclusion is available for transfers from children to parents as well as from parents to children. Rev. & Tax Code, § 63.1(c)(1).

29. Rev. & Tax. Code, § 63.1(a)(3)(A).

30. The amendment to section 63.1(a)(3)(A) applies to the lien date for the 2006–2007 fiscal year and each fiscal year thereafter.

31. The authors are uncertain regarding the consequences of the transfers to Daughter-in-law and Grandchild in this example. If the property qualifies as Transferor's principal residence when it is first transferred to the trust, does the property continue to qualify as Transferor's principal residence when Daughter-in-law becomes the present beneficiary on Son's death and when the property is distributed to Grandchild at the termination of Daughter-in-law's interest? While the authors believe the answer should be "yes," they are aware of no authority on this issue. If the property does not qualify as Transferor's principal residence when it is transferred to the trust for Son's benefit, the full cash value of the property at that time will be charged against Transferor's $1 million exclusion if the parent-child exclusion is claimed. Would it also be necessary to charge the full cash value of the property at the time of Son's death against what remains of Transferor's $1 million exclusion after the transfer to Son if the parent-child exclusion is claimed for the transfer to Daughter-in-law and to charge the full cash value of the property when Daughter-in-law's interest terminates against what remains of Transferor's $1 million exclusion after the transfers to Son and Daughter-in-law if the grandparent-grandchild exclusion is claimed for the transfer to Grandchild? In other words, although a single property is involved, would each of the three events be treated as a separate transfer requiring its own allocation of Transferor's $1 million exclusion? The authors are unaware of any authority on these issues.

32. Rev. & Tax. Code, §§ 63.1(a)(2), (a)(3)(A).

33. Rev. & Tax. Code, § 63.1(a)(3)(B).

34. Rev. & Tax. Code, § 63.1(a)(3)(B).

35. Letter to taxpayer dated April 6, 1992, Annotation No. 625.0230.

36. See unannotated Letter to taxpayer dated July 8, 1998, involving similar facts except the property was transferred to the settlor's Daughter during her husband's lifetime pursuant to the exercise of a limited inter vivos power of appointment.

37. Rule 462.160(b)(1)(A); Letter to Placer County Assessor dated July 22, 2002, Annotation No. 220.0821.

38. Rule 462.160(b)(1)(A), Example 3.

39. Rule 462.160(b)(1)(A), Example 2.

40. Letter to Santa Barbara County Assessor dated December 14, 1993, Annotation No. 220.0774.

41. Rule 462.160(b)(1)(A); Letter to Placer County Assessor dated July 22, 2002, Annotation No. 220.0821; Letter to taxpayer dated July 18, 2001, Annotation No. 625.0236. Note that a 1993 SBOE opinion letter interpreted the rules concerning sprinkle powers more narrowly. In its Letter to Santa Barbara County Assessor dated December 14, 1993, Annotation No. 220.0774, the SBOE considered a transfer of property to a trust whose terms granted the trustee sprinkle power to distribute the property to the spouse, children, or grandchildren of the transferor. The SBOE stated that the interspousal exclusion would apply if the spouse of the settlor was the only beneficiary and that the parent-child exclusion would apply if the children were the only beneficiaries. The letter does not appear to allow either the interspousal exclusion or the parent-child exclusion if both the spouse and children are present beneficiaries. The 1993 letter is contradicted by Rule 462.160(b)(1)(A) and superceded by the two SBOE letters cited above, which cite Rule 462.160(b)(1)(A). Although it might be possible to distinguish the 1993 letter on the grounds that it involved a power subject to an ascertainable standard, while the rule and the 2001 and 2002 letters involve unlimited trustee discretion, SBOE counsel have indicated to the authors that the result should be the same regardless of whether the trustee's discretion is unlimited or subject to an ascertainable standard such as health, education, support, and maintenance.

42. Rule 462.160(b)(1)(A), Example 2.

43. Letter to Santa Barbara County Assessor dated December 14, 1993, Annotation No. 220.0774.

FN. 43. This was deleted from the annotations in January 2007.

44. Letter to Monterey County Assessor dated May 23, 1989, Annotation No. 220.0158.

45. Letter to taxpayer dated June 16, 1995, Annotation No. 220.0775, and Letter to Sutter County Assessor dated June 19, 1987, Annotation No. 220.0785.

46. See Letter to taxpayer dated April 18, 1988, Annotation No. 625.0220.

47. Letter to taxpayer dated February 8, 1999, Annotation No. 625.0218.

48. Letter to taxpayer dated July 18, 2001, Annotation No. 625.0236.

49. Letter to taxpayer dated January 4, 2006, Annotation No. 220.0822.

50. Letter to taxpayer dated December 26, 1990, Annotation No. 220.0771.

51. Letter to taxpayer dated December 26, 1990, Annotation No. 220.0771, citing *Estate of Thorndike* (1979) 90 Cal.App.3d 468, 473 and *Estate of Kuttler* (1959) 160 Cal.App.3d 332, 338.

52. Letter to taxpayer dated April 6, 1992, Annotation No. 625.0230 and Letter to taxpayer dated December 26, 1990, Annotation No. 220.0771.

53. Letter to taxpayer dated April 6, 1992, Annotation No. 625.0230.

54. Letter to taxpayer dated April 6, 1992, Annotation No. 625.0230. This analysis appears to be somewhat questionable since the beneficiary would not be able to withdraw the entire property over a 20 year period. Assume, for example, that the only trust asset is a single property and that the beneficiary wishes to maximize his or her withdrawals. The beneficiary could withdraw 5 percent of the property in the first year, 4.75 percent [5 percent of the 95 percent interest remaining in the trust after the first year's withdrawal] in the second year, 4.5125 percent [5 percent of the 90.25 percent interest remaining in the trust after the second year's withdrawal] in the third year, and so on. After 20 years, the beneficiary would have been able to withdraw interests in the property totaling approximately 64.15 percent, leaving an interest of approximately 35.85 percent in the property remaining in the trust. Over time the percentage of the property withdrawn by the beneficiary would approach, but never reach, 100 percent.

55. This position would appear to be correct because the California law definition of a general power of appointment does not contain a "five and five" exception similar to those contained in Internal Revenue Code sections 2041(b)(2) and 2514(e). Prob. Code § 611.

56. See I.R.C. § 2041(b)(2). Similarly, under I.R.C. § 2514(e) the lapse of the withdrawal power would not be treated as a taxable gift by the beneficiary.

57. See language in synopsis of Annotation No. 625.0210 (but not the underlying Letter to taxpayer), which provided that if a special power of appointment is "not exercised or disclaimed by the holder of the special power, such power is ineffective and the property subject to appointment passes from the creator of the power to the beneficiary."

58. Letter to taxpayer dated December 14, 1990, Annotation No. 625.0234; Letter to taxpayer dated January 21, 1992, Annotation No. 220.0210; unannotated Letter from Timothy Boyer, then Chief Counsel SBOE, dated July 8, 1998; see also Letter to taxpayer dated December 26, 1990, Annotation No. 220.0818; unannotated Letter from Kristine Cazadd, current Chief Counsel SBOE, to taxpayer dated January 20, 2000; but see Letter to taxpayer dated January 4, 2006, Annotation No. 220.0822.

59. Unannotated Letter from Richard S. Moon to taxpayer dated March 27, 2006, and unannotated Letter from Kristine Cazadd, current Chief Counsel SBOE, to taxpayer dated January 20, 2000.

60. Unannotated Letter from Richard S. Moon to taxpayer dated March 27, 2006.

61. This discussion of non-prorata distributions applies to the transfer of property through trusts. The analysis for property transferred by will is similar, although not identical. As discussed in the article, an assessor will assume the trustee has the power to distribute trust assets non-prorata, unless the trust instrument prohibits non-prorata distributions. With a will, an assessor may assume property will pass to the estate beneficiaries in equal shares, unless the will specifically grants the executor the power to make non-prorata distributions. See LTA No. 1991/08 and Letter to taxpayer dated August 6, 1990, as amended, Annotation No. 220.0767.

62. LTA No. 1991/08 and Letters to taxpayer dated August 6, 1990 and September 10, 1996, as amended, Annotation No. 220.0767.

63. Letters to taxpayer dated August 6, 1990 and September 10, 1996, as amended, Annotation No. 220.0767. Unless the trust instrument specifically prohibits non-prorata distributions, non-prorata distributions are permitted under Probate Code section 16246, which provides that "the trustee has the power to effect distribution of property and money in divided or undivided interests and to adjust resulting differences in valuation." Note that a trustee will not have the power to make non-prorata distributions if the trust instrument does not affirmatively authorize non-prorata distributions and trust administration is governed by the law of a state that does not permit a trustee to make non-prorata distributions unless the trust instrument provides authorization to do so.

64. See Handout and lecture of Kristine Cazadd, current Chief Counsel SBOE, March 3, 2004; See also LTA No. 91/08 dated January 23, 1991 regarding general principles.

65. Memo to File from Kristine Cazadd, current Chief Counsel SBOE, dated June 4, 2004.

66. Memo to File from Kristine Cazadd, current Chief Counsel SBOE, dated June 4, 2004.

67. See SBOE Letter to Monterey Assessor dated August 4, 2003, Annotation No. 625.0235.005.

Notation to Paragraph V.C.2. on Page 14 of *Understanding Property Tax Treatment of Trusts*

The discussion of option 2, "Alternative – Note and Deed of Trust from Beneficiary," on p. 14 of the article is cited as being pursuant to a June 4, 2004, SBOE memorandum. In September of 2007, the authors circulated an email among the Trusts and Estates Section members which stated, in part:

> The SBOE no longer supports the alternative method of having the beneficiary receiving the property execute a note and deed of trust in favor of the trustee. An internal memorandum of the SBOE dated September 5, 2007,[1] specifically refers to the article, and states that the alternative method is not a viable option for encumbering the property. Although the September 5 memorandum does not acknowledge the SBOE's June 4, 2004, memorandum that we cited as authority in our article, SBOE counsel has confirmed verbally by phone that the September 5 memo reflects the SBOE's current position and directly contradicts the June 4, 2004, memorandum.
>
> The SBOE's change in position is significant – the SBOE now specifically disapproves of having a trustee encumber property by distributing property to a beneficiary in exchange for a promissory note and deed of trust. The September 5 memo is clear that the trustee may encumber the property only with a loan made by a third party, or, alternatively, with a loan made by a beneficiary not receiving the property.

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[1] This September 5, 2007, memorandum is included with the correspondence of SBOE Annotation 625.0235.005.