



## Winter 2020 Bulletin

### **EXTREMELY IMPORTANT – PLEASE READ** **SIGNIFICANT CHANGES TO PROPERTY TAX REASSESSMENT RULES**

On November 3, 2020, voters in California passed Proposition 19, which contained two (2) extremely important changes to California's property tax reassessment rules that will impact and have profound consequences on the transfer of real property between parents and children and grandparents to grandchildren. Parents who transfer their real property to their children or grandparents who transfer their real property to their grandchildren after the effective date of Proposition 19 will cause a property tax reassessment. Proposition 19 limits the availability of the parent-child exclusion for real property tax reassessments. The alarming aspect of this change in the law is that **it takes effect on or after February 16, 2021.** California real property owners who want to transfer real property to their children without property tax reassessment have approximately two (2) months to plan for those real property transfers before Proposition 19 takes effect.

#### **Current Law**

Under current law, the real property's base year value for property tax assessment purposes is not reassessed when a parent transfers ownership of his or her principal residence to a child, regardless of how the child uses the residence. In California, transferring a parent's home to one or more children is permissible under current law without triggering reassessment, and the child or children can use the home as a vacation home or a rental property. Children who inherit their parents' residence

and other real property with an assessed value of \$1 million per parent (not fair market value), receive their parents' Prop 13 factored base year value, instead of the current market value, when the children receive the property.

#### **Prop 19 Changes**

Proposition 19 eliminates: (i) the parent-child/grandparent/grandchild exclusion from property tax reassessment for transfers of a residence between parents and children and grandparents and grandchildren; and (ii) the transfer of \$1 million of assessed value of additional real property. To receive the parent-child exclusion, Prop 19 requires that the child or children use the residence as their own principal residence within one (1) year of the transfer or it will be reassessed. Even if the child uses the residence as his or her own residence, the exclusion is no longer unlimited in value and will only exclude up to an additional \$1,000,000 of value (indexed for inflation based on the California House Price Index) on the exclusion as explained below. Children who do not want to move into their parents' home or want to use their parents' home for vacation, investment, or commercial purposes, will pay property taxes based on the market value of the real property as of the date of transfer rather than their parents' Prop 13 factored base year value.

Owners of real property which are highly appreciated, but have a low assessed value for property tax purposes, who are

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considering transferring that real property to their children should consider making those gifts before February 16, 2021. Children who want to retain their parent's vacation property, or investment or commercial property should make those gifts to their children before February 16, 2021.

With regard to a transfer of a family farm to a child or children, Prop 19 appears to treat the transfer the same as the transfer of a principal residence for parent-child exclusion purposes. There is no requirement that the parent or children farm the property or be involved in farming the property in any way. The property may be leased to a third party. A family farm is basically any farm (under cultivation, pasture, or grazing) or any property "used to produce any agricultural commodity".

It may also be beneficial to make the gifts at the present time, because the federal gift and estate tax exemption is \$11,580,000 in 2020. Taxpayers should keep in mind that the federal estate tax exemption will revert to the 2017 level of \$5 million, adjusted for inflation, on January 1, 2026.

Because of the difference in the income tax basis of real property between gifting property to children versus the children receiving property upon a parent's death, real property owners must always balance the property tax benefits of lifetime gifts of real property with the income tax consequences of gifting the real property. At death, the income tax basis of property included in the decedent's gross estate is

adjusted to the property's market value at date of death (**step-up in basis**). Donees of lifetime gifts do not receive the step-up in basis, but take the transferor's basis as their basis in the property for income tax purposes. Gifts completed before February 16, 2021 may be the only way to preserve a parent's low Prop 13 factored base year value. The property tax benefits achieved by gifting real property must be balanced, with the income tax consequences of a lifetime transfer of the real property, which will not result in a step-up in basis.

This change to the parent-child exclusion may also affect many common estate planning trusts that were established several years (or even decades) ago. For example, a qualified personal residence trust (QPRT) allows the transfer of a residence to a trust, while that residence can still be occupied by the parents for a fixed number of years. The parent(s) continue to live in the residence as their primary residence and, at the end of the fixed number of years, the residence transfers to someone else (typically their children or a trust for the children's benefit). Most parents want to continue living in the house after the QPRT's fixed term ends. They may do so, but they need to pay rent to the trust or to their children, depending on who owns the residence at the end of the fixed term.

Under existing law, the children qualify for the parent-child exclusion, when the children become the owners of their parents' home. But Prop 19 requires the



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children to use the residence as their primary residence or the residence will be reassessed. They could not rent it back to the parents, and, if siblings are entitled to the residence at the end of the fixed term, they would need to move in together and share a household to qualify for the exemption (not ideal for most adult children). If parents have QPRTs whose fixed term ends on or after February 16, 2021, the value of their home may be reassessed to its current value. This could lead to a massive property tax increase, though it may be possible to mitigate this property tax increase.

#### **Amount of Increase in the Assessed Value**

If your home has increased in value significantly from its Prop 13 factored base year taxable value, Prop 19 adds certain limitations that could result in an increased assessment. This new rule will apply to outright transfers and to transfers in trusts, such as the QPRT transfer illustrated above. If the increase in value is less than or equal to \$1,000,000, no adjustment is made. If the increase in value is more than \$1,000,000, the increase in value after the first \$1,000,000 is added to the tax assessed value. For example, assume a parent's home has a taxable value of \$3,000,000. Because the parent purchased the home many years ago, its value is now \$5,000,000. In other words, its value has increased by \$2,000,000. The new reassessed value if the parent gifts the home to the child will be \$4,000,000. There are inflation adjustments that apply to the \$1,000,000 increase limitation for subsequent years.

#### **Changes to the Transfer of Taxable Value for certain Property Owners**

The other significant change in Prop 19 is generally beneficiary to homeowners and takes effect on April 1, 2021. Prop 19 expands the class of people who qualify for a transfer of their taxable value from their current home to a new property.

Under existing law, only homeowners over 55 years of age or certain disabled persons could make use of this benefit and they could do so only if: (i) their new home is in the same county as their old home; and (ii) the value of their new home is less than or equal to the value of their old home.

The new law expands the class of homeowners who are able to transfer their taxable value to include victims of wildfire or other natural disasters and hazardous waste contamination, regardless of age or disability status. In addition, the new law removes the restriction that the replacement home must be in the same county as the old home. The new law allows homeowners to buy a replacement home that is worth more than their old home; provided, however, that the increase in value is added to the transferred taxable value of the old home.

For example, assume a homeowner is over 55. Her house has a taxable value of \$5,000,000. She sells it for \$15,000,000. If she buys a new home anywhere in California for \$15,000,000 or less, she can transfer her \$5,000,000 taxable value to the new home. This will be its taxable value; however, if she wants to upgrade to a



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\$20,000,000 home, her new home's taxable value will be \$10,000,000 – the taxable value of her old home transferred (\$5,000,000) plus the upgrade value (\$20,000,000 - \$15,000,000).

Though no real planning needs to be done in connection with this change in the property tax assessment rules, these new rules that apply to transferring taxable value is something of which homeowners should be aware. The ability to transfer this taxable value is not automatic and homeowners who wish to make use of the benefit must apply for the benefit by filing a claim with the assessor that provides certain information required by the statute. The homeowner can apply this reduction in property tax value three times if over 55 years old or with severe disabilities (disaster and contamination victims would continue to be allowed one transfer).

Prop 19 will change some of our current strategies and create new opportunities for us to assist our clients with regard to the transfer of real property. We will need to rely on planning that use business entities to acquire, hold, and transfer real property that are not affected by Prop 19.

Please contact our office if you have any questions or concerns.