Winter 2021 Bulletin

PLANNING FOR PROPOSITION 19
EXTREMELY IMPORTANT

Proposition 19 may be important to you if ALL five of the following circumstances exists:

1. You own one or more parcels of California real estate and the current fair market value of one or more of your properties is much higher than the assessed value of the property for property tax purposes. You can find the assessed value of any property on your annual property tax bill.
2. If you have at least one child and there are several parcels of real estate that one or more of your children want to retain after you die. Proposition 19 planning can be especially beneficial when the property is a residence that a child will occupy or a vacation home that will be used by the family (not a rental property). It is rare for a child to want to occupy his or her parent's residence for a lengthy period of time.
3. You can afford to give away the real estate (including most or all of the income from the real estate) to irrevocable trusts for your children) before February 16, 2021. Furthermore, if you need to retain some cash flow, or if you want to give away your residence, but cannot afford to pay fair market value rent, then you may still be able to benefit from an installment sale to an intentionally defective grantor trust ("**IDGT**"), but this planning is significantly more complicated and involve additional risk.
4. Your property is not held in a partnership or LLC that purchased the property in a transaction that resulted in a reassessment. Please note that if your property is held in a partnership or LLC that purchased the property in a transaction that resulted in a reassessment, then you are in the best possible position and, with proper planning, can avoid any property tax reassessment. It's probably a bad idea to acquire any new real property using an existing partnership or LLC, because this would restrict the ability to eventually move ownership as desired over generations. As suggested below, it probably makes sense to form a new LLC whenever a client acquires a new property so that, ideally, each LLC owns only one property, thereby eventually creating more flexibility in allocating particular properties to "branches" of your family.
5. You have not already fully consumed your Proposition 58 exclusion as to properties other than the primary residence and using your unlimited exclusion as to your primary residence is not appealing. Please note that information regarding your prior use of Proposition 58 and Proposition 193 exclusions can be obtained from the California Board of Equalization.

Under California Proposition 13, the assessed value of real estate for property tax purposes is generally based on the purchase price plus an increase of 2% per year. Because California real estate has generally appreciated at a rate that is much higher than 2%, it is not unusual for a property to have an assessed value that is substantially less than the fair market value.

Under Propositions 58 and 193, clients have been able to pass some or all of the benefit of Proposition 13 to their children and grandchildren. Proposition 19 is going to eliminate this "loophole" except with respect to a

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primary residence, and even the loophole for a primary residence is going to be severely restricted.

The loss of the parent-child exclusion creates a significant incentive for you to transfer interests in California real estate outright to your children or to trusts for your children before the effective date of Proposition 19, which is February 16, 2021.

In order to avoid Proposition 19, you must give away property to your children or trusts for your children before February 16, 2021, or perhaps use one of the other strategies described in this Bulletin. The optimum strategy to mitigate the consequences of Proposition 19 will depend on your situation and objectives. It may be possible to save $100,000 or more per year in property taxes after you die, but there are important hurdles and risks that must be addressed.

The biggest hurdle to avoid Proposition 19 is preserving the step up in basis that would normally be available upon your death. Under Internal Revenue Code ("**IRC**") Section 1014, subject to certain exceptions that almost certainly will not apply to California real estate owned at death, if someone dies owning an interest in real property, the tax basis is, for income tax purposes, adjusted to equal the fair market value of the decedent's interest in the property on the date of death (or, if elected under IRC Section 2032, the alternate valuation date).

For example, assume that you purchased an apartment building in 1980 for $1 million and that you have taken depreciation deductions totaling $500,000 since you purchased the building. Your current income tax basis in the building would be $500,000. Assume that since you purchased the property, the value of the building has increased to $10 million. If you were to sell the building while you are alive, then you would have a taxable capital gain of $9,500,000, based on a sales price of $10 million minus your tax basis of $500,000 (on account of the $500,000 of depreciation taken over the ten years). Before Proposition 19, property owners would hold onto the building until they die, at which point the step up in basis would increase the income tax basis to the fair market value of $10 million, and the beneficiaries of the property owner's estate plan could either sell the building on a tax-free basis or keep the building and begin taking depreciation deductions based on the $10 million estate tax value.

Now that Proposition 19 has passed, you may want to give some of your interests in real estate to your children before February 16, 2021, but, without proper planning, this will result in forfeiting the step up in basis when you die.

Proper panning requires that transfers to children or trusts for children are completed for California property tax purposes before February 16, 2021 in order to use your Proposition 58 exclusions, before these exclusions are taken away by Proposition 19. As discussed in detail below, very careful planning is required to preserve a step up in basis at your death, while creating a completed transfer for California property tax purposes.

Proposition 58 allows an unlimited exclusion with respect to the assessed value of a transfer of a principal residence to children. For example, a parent could transfer a primary residence with

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an assessed value of $10 million to a child without reassessment; however, with respect to property that is not the parent's principal residence, the Proposition 58 exclusion is limited to $1 million of assessed value per parent. The following strategies may allow a family to avoid reassessment with respect to a property that has an assessed value greater than $1 million.

LLC Strategies

One Child Example

Status Quo: Parent owns a shopping center with an assessed value of $2 million.

Step 1: Before February 16, 2021, parent transfers a 50% interest in the shopping center to a child (or a trust for the child). The transfer avoids a reassessment by completely using a parent's $1 million parent-child exclusion.
Step 2: Parent and child create an LLC and contribute their respective 50% fee interest to the LLC in exchange for 50% interests in the LLC. This transfer to the LLC avoids a reassessment under the "proportionate transfer rule".
Step 3: Before parent dies or upon parent's death, parent's 50% LLC interest is transferred to someone other than the child. This transfer of entity interests should be exempt under Revenue and Taxation Code Section 64(a). In particular, the following exceptions should not apply:

(i) Under Revenue and Taxation Code Section 64(c)(1), a change of ownership occurs when any person "obtains a majority interest in any entity "through the purchase or transfer of" ownership interests in that entity. If parent's remaining LLC interest had been transferred to the child in Step 3, then the child would acquire 100% ownership and Revenue and Taxation Code Section 64(c)(1) would be triggered. By transferring the parent's remaining LLC interest to another person, such as a grandchild, this is avoided.

(ii) Under Revenue and Taxation Code Section 64(d), a change of ownership occurs when any "original co-owner" transfers, in one or more transactions, ownership interests "representing cumulatively more than 50% of the total interests in the entity". If any more than 50% were transferred in Step 3, then this provision would be triggered and the property would be reassessed.

(iii) When the Step Transaction Doctrine applies, the government can treat the final outcome of a transaction as having been reached through a different set of intermediate steps, (i.e., steps which trigger more taxes). The assessor might disregard the creation of the LLC in Step 2, and treat the second transferee as having received his 50% via an assessable outright transfer of real property or, the assessor might view the transfer in Step 1 as a transfer of LLC interests, in which case the transfer at Step 3 would be assessable under Revenue and Taxation Code Section 63(c).

In this transaction, you might consider a few steps to reduce (but not eliminate) the Step Transaction Doctrine:
(1) Maximize the delay between Steps 2 and 3, by delaying the final transfer of LLC interests until the parent's death;
(2) Document that the LLC serves a legitimate non-tax purpose, such as protecting the owners from liability arising from the use of the property; and

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(3) To reduce the likelihood of the application of the Step Transaction Doctrine, it might help to postpone the contribution into the LLC in Step 2 for a year or longer.

Multiple Children Example

Assume the same facts as in the first example above, except that there are two children and parent gives a 25% interest in the property to each child (or trust for a child). Then the parent and children (or trusts for children), transfer their interests to an LLC. Each child would receive half of the parent's 50% interest in the LLC after the parent's death without reassessment, because there would be no violation of the cumulative transfer rule or the change of control rule. This strategy could be also adapted to situations where there are more than two children.

Final Step

At the conclusion of the steps in the example above, the children (or trusts for children) will hold LLC interests. If they continue to hold the property in this manner until the parent dies, then when any one of the children subsequently dies, this will trigger the "cumulative transfer" rule in Revenue and Taxation Code Section 64(d), causing reassessment of the entire property (including the portions not transferred). To prevent this, the parties want to dissolve the LLC after the parent's death and take title as tenants in common.

Joint Tenancy

Creating joint tenancies can provide a relatively simple solution for deferring reassessment after a parent dies, while also achieving estate inclusion and a step-up in basis, but this approach has certain risks and uncertainties and may not achieve your non-tax objectives.

Pursuant to Revenue and Taxation Code Section 65 and Property Tax Rule 462.040, the following strategy seems viable:

Step 1: Parent owns 100% of Blackacre. Parent transfers a 25% interest to each of parent's three children.
Step 2: Parent and the three children transfer the property to themselves as joint tenants with right of survivorship.

If this sequence is followed, then parent and each child should be treated as an "original transferor". Furthermore, there should be no reassessment until the death of the last survivor of the "original transferors".

This strategy may offer a simple and inexpensive way to postpone reassessment until the last to die of parent(s) and children; however, there are significant drawbacks and risks:

(i) If multiple children are included or if only one child is included, but that child predeceases parent(s), then the descendants of the deceased child will not receive their expected interests, absent some special provisions in the parent(s)' estate plan or some "side agreement".
(ii) The property will be exposed to creditors of the children who are part of the joint tenancy.
(iii) The assessor may make a step transaction argument, though a Property Tax Rule suggests that argument seems unlikely in this context.

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If this strategy is used, then additional planning should be considered after the parent's death. For example, at that point it may make sense for the children to sever the joint tenancy and do something else.

Because Proposition 19's text does not explicitly answer many questions or is ambiguous, a number of the Board of Equalization ("**BOE**") answers are based on the perceived intent of the Legislature and voters. Therefore, the Legislature should make clear the answer to these and other questions in follow-up legislation as contemplated by Proposition 19, which states that the Legislature will enact legislation detailing "procedures and definitions".

In the future, you should almost always use an LLC or partnership to purchase any California real estate, and that includes personal residences that will constitute community property. The reason to do so is, if an LLC is the original purchase from a third party in a transaction that results in a reassessment for property tax purposes, then the LLC can avoid any future reassessment because there is no "change of control" for property tax purposes. A change of control for property tax purposes means a situation in which someone other than your spouse ends up with more than 50% of the LLC interests. As long as you have at least two children, or at least one child and at least one grandchild, it should be easy to structure the estate plan so that no one person ever ends up with more than 50% of the LLC. And even if there is only one child and no grandchildren, it should be possible to avoid reassessment by having a 50% interest pass to, or in trust for, the child and a 50% interest sit in a trust for charity until another child is born or until the existing child has one or more children.

Irrevocable Trusts

Many tax practitioners are advocating the use of irrevocable trusts with certain provisions in the trust agreements that will avoid estate inclusion. A discussion of this technique is too complicated to discuss in this Bulletin.

Please note that using an LLC to purchase a residence may make it more difficult to obtain a mortgage. It is possible that you will need to provide a personal guarantee in order to make this work, and you should find a lender who will make a loan before signing a purchase offer.

If you have any questions regarding the strategies discussed in this Bulletin, please contact our office.

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