

Proposition 19

The current law allows for a personal residence to be distributed to a child without a reassessment regardless of the value of the residence. In addition, other real property in the aggregate of one million dollars can avoid reassessment.

Proposition 19 passed on November 3, 2020 significantly limits the ability of parents to leave real estate to their children without a reassessment of property taxes.

On December 11, 2020 the California Board of Equalization (BOE) issued guidance to the County Assessors. The BOE states Proposition 19 adds new provisions for a base year transfer of a primary residence.

Background. All levels of government are looking for more revenue, especially revenue that is not a clear hike in income or gift and estate tax. Another example is the SECURE Act that will raise billions without increasing taxes by no longer permitting children/grandchildren to 'stretch out' IRA distribution for their life expectancies.

Proposition 19 was marketed as a provision to benefit homeowners who are over 55, the disabled, and wildfire/disaster victims. The proponents also said it would fix a loophole that permits wealthy persons/celebrities from leaving their residences to their wealthy children without a reassessment and not requiring the children to live on the property – they could rent it. Many groups (political parties, and other special interest groups) send out recommendations regarding voting each election. Curiously, many refrained from a recommendation on this Proposition.

The truth is that this proposition contains significant property tax increases that will be borne by children and grandchildren who receive real property from parents and grandparents. This affects not just the wealthy, but all families – even if the only asset in the estate is the residence. Further, it will prevent some children from keeping the residence because of the increase in property tax.

There are some good aspects, which were hyped by the proposition proponents, such as extending the avoidance of reassessment for a primary residence for persons if they meet the filing requirements¹ and are:

- At least age 55; or
- Severely disabled; or
- Victims of wildfires or natural disasters.

¹ **Filing Requirements.** In order to receive this property tax benefit, the transferee must claim the homeowner's or disabled veteran's exemption at the time of the purchase or transfer of the family home. If the claim is not filed at the time of the purchase or transfer, the transferee has one year from the date of purchase or transfer to file the claim for the homeowner's or disabled veteran's exemption and shall be entitled to a refund of taxes previously owed or paid between the date of the transfer and the date the transferee claimed the homeowner's or disabled veteran's exemption.

Now the bad news. Proposition 19 is complex. Beginning on and after February 16, 2021, the family home² of a parent will only avoid reassessment and higher property taxes if:

- The child³ continues to use the property as the child's family home; and
- The child does so within one year after the parent's death.

If those two hurdles are navigated, and the fair market value⁴ of the family home is less than the sum of the factored base year⁵ value plus \$1,000,000, then the factored base year value need not be adjusted. The \$1 million Parent-Child Exclusion from reassessment is per parent. As a result, a couple can transfer to their children a total of \$2,000,000 of assessed value in real property during the parent's lifetime.

But if the value of the personal residence exceeds the assessed value⁶ of the personal residence plus one million dollars⁷, then there will be an "adjustment," meaning higher taxes.

Gifts. For those who have not made larger gifts, the Federal Estate and Gift Tax Exemption of \$11,700,000 per donor is available. This allows many property owners to gift properties to their children without the imposition of federal gift tax. California does not have a state gift tax.

Note that the Federal Estate and Gift Tax Exemption, which is currently set to expire on December 31, 2025, may be reduced by an act of Congress signed by the President as early as 2021.

² California Constitution, Section 2.1(e)(3) provides that a "family home" means a principal residence that must be eligible for the homeowner's or disabled veteran's exemption. Hence a Homestead Exemption should be filed. Section 2.1(c)(1) allows the purchase or transfer of a "family home of the transferor" to be excluded from reassessment, if the property "continues as the family home of the transferee." Thus, the family home must be the principal residence of both the transferor and the transferee.

A "family home" also includes a family farm that contains a principal residence. A "family farm" is real property that is under cultivation or which is being used for pasture or grazing, or that is used to produce any agricultural commodity. "Agricultural commodity" means any and all plant and animal products produced for commercial purposes, including, but not limited to, plant products used for producing biofuels and cultivated industrial hemp.

³ These provisions also apply to a purchase or transfer of a family home between grandparents and their grandchildren, as long as all of the parents of those grandchildren, who qualify as children of the grandparents, are deceased as of the date of the purchase or transfer.

⁴ "Full value" is defined in section CA RTC section 110.5 as fair market value.

⁵ The base year value is set when you originally purchase the property, based on the sales price.

⁶ "Assessed value" is defined in CA RTC section 135 as 100 percent of full value. "Taxable value" means the base year value plus inflationary factoring (i.e., factored base year value

⁷ Note that beginning February 16, 2023, and every other February 16 after that, the \$1,000,000 will be adjusted by the percentage change in the House Price Index for California for the prior calendar year, as determined by the Federal Housing Finance Agency. The State Board of Equalization will release this information biennially via Letter To Assessors.).

Gift-giving involves multiple financial and tax issues:

- Property transferred by gift takes a carry-over basis while property transferred at death, under current law, receives a step up in income tax basis;
- Gift-giving results in a loss of control;
- An outright gift exposes the property to the donee's creditors; and
- Remember, a gift tax return must be filed, and an appraisal may have to be obtained.

Discussion:

Many are panicked by this new law and are rushing to make gifts outright or in trust to their children. The situation should be carefully considered before taking action, for example:

- A parent may rely on the income being produced by real estate for living expenses and gifting the property results in a loss of that income;
- Children may ultimately want to liquidate property after the parent dies;
- If children acquire carry over basis property received from a lifetime gift, they lose the step up in basis at the death of the parent, subjecting them to capital gain taxes on sale of the property. Property tax versus Capital Gains tax; and
- There are situations where gift-giving might be appropriate. Especially where the child expects to retain the property indefinitely. Keep in mind that it will only protect the next generation.

Some attorneys are doing irrevocable trusts and trying to use powers of appointment to treat the transfer as a gift and allow for a step up in basis at death. This route requires an attorney who understands these issues.⁸

As with many anticipated losses relating to taxation, some families are turning to life insurance to make up the difference.

In any event, if there is a desire to gift real property to children to avoid Proposition 19, it must be done now! The deadline is February 16, 2021. (Note: However, the true deadline is **February 11, 2021**, due to county office closures for Lincoln's Birthday and President's Day.)

If you miss the deadline, do not lament. There may be opportunities to do post deadline planning.

⁸ For example, a parent might gift residential or rental property to an irrevocable trust that requires the parent (creator of the trust) to still pay the income taxes. The trust is for the benefit of children. The real property transferred should qualify for parent child exclusion. The parent is also the trustee and perhaps an investment trustee. There is an independent trust protector (which provides flexibility). Parent can get income as the property manager, as investment advisor, and as trustee. If the property is the parent's residence they can still live there and pay rent to the trust. The parent maintains distribution control by retaining a limited testamentary power of appointment.