CALIFORNIA PROPOSITION 19 PASSED. IMMEDIATE EFFECT ON REAL PROPERTY TAX PLANNING.

January 8, 2021

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On November 3, 2020, California voted to pass Proposition 19. That Proposition has a substantial impact on planning for many clients that own real property in California, especially real property used in the conduct of a trade or business. It may be advisable to transfer California real property that you plan to leave to your children or grandchildren before February 15, 2021, if you want to avoid a real property tax reassessment of that property following the completion of the transfer to the child/children, as summarized in this article.

There are three major effects this new law will have on California real property owners:

(1) Elimination of $1 Million Exclusion for Commercial, Rental, Investment, and Vacation Properties: Prior to Prop. 19's passage, a parent could transfer the parent's primary residence and up to $1,000,000 of assessed value of other property (commercial property, rental properties, investment properties, vacation homes, and vacant lots) to their children and such properties would retain the low adjusted base year assessed value used by the parent for purposes of assessing property taxes due on that property following that transfer. In effect, following the transfer, the property taxes would stay substantially the same as those applicable to the parent prior to the transfer to children. In addition, if a child of the transferor-parent was deceased at the time of the transfer, the parent-child exclusion could be applied to a transfer from the transferor-parent to the children of that deceased child (i.e. the transferor-parent's grandchildren).

Prop. 19 eliminates the parent-child and grandparent-grandchild exclusion from reassessment for properties other than the primary residence. Thus, children receiving gifts of real property or inheriting real property from their parents (other than the primary residence) on or after February 15, 2021, will see a substantial increase in real property taxes assessed on such gifted or inherited property. This increase in real property tax may and likely will have a dramatic impact on the profitability of many California family-owned and operated businesses, especially those engaged in agriculture and/or live stock.

(2) Major Changes in Parent-Child Primary Residence Exclusion: Currently, the parent-child exclusion for transfers of a primary residence or "family home" from a parent to his/her children is unlimited in amount and the transferee is not required to use the home as a primary residence. This exclusion was frequently used when designing and implementing a "qualified personal residence trust" (QPRT) pursuant to which the parent was able to transfer the residence to a child or children at a substantially reduced value for federal gift and estate tax purposes and without incurring an increase in real property taxes.

(A) Decrease in Amount of Exclusion: Prop. 19 reduces the parent-child exclusion on a primary residence or "family home" from an unlimited amount to the amount of one million dollars above the current assessed value. As such, if a parent transfers his or her primary residence to a child who meets the residence requirement discussed below, on or after February 15, 2021, there could and likely will be an increase in the real property taxes due on that property depending on the difference between assessed value of the property with respect to the transferor-parent(s) and the reassessed value of the property as of the date of transfer (i.e. date of the gift or date of death of the transferor-parent). Many homes in California are currently worth more than one million, and are likely to increase in value in the future.

(B) Child Must Live in Primary Residence to Receive Tax Benefit: Prop. 19 still requires the parent (transferor) to live in the "primary residence" but now further requires the child (transferee) to live in the primary residence following the transfer, in order to qualify for the parent-child exclusion. This poses a major complication for clients with several children as it is unlikely that more than one child of the transferor will want to occupy his/her parents' primary residence as his/her own residence since most adult siblings want to provide living quarters for themselves and their families that are separate from the residences of their other siblings, and the parent(s) may be unable or unwilling to leave the entire primary residence to one of the several children.

(3) Multiple Transfers Now Available to Homeowners with Disabilities, Affected by Natural Disasters, and/or Over Age 55: Under the current law, a homeowner over age 55 can transfer the assessed value applicable to a current primary residence to a newly acquired primary residence provided the newly acquired residence is of equal or lower value than the existing primary residence, and that transfer could occur only once during the homeowner's lifetime.

Prop. 19 changed the law to allow eligible homeowners transfer the assessed value of a current primary residence to a newly acquired primary residence located anywhere within the state of California, even if the value of newly acquired residence is greater than the value of the current residence, and homeowners over age 55 can make this transfer up to three times during their lifetimes. Other homeowners who are now eligible to make this transfer include those with severe disabilities or those who lost their homes in a natural disaster (i.e. wildfires). This appears to be the only benefit provided under Prop. 19, and is a tool that should be carefully considered by individuals who are severely disabled, who have lost their homes to a natural disaster and/or are over age 55.

Certain estate planning opportunities designed to utilize the provisions applicable to real property taxes before the effective date of Prop. 19 (i.e. February 15, 2021) may be implemented if the planning is completed on or before February 14, 2021. These planning opportunities include:

(1) Outright Gift of Real Property to Children: If the parent does not need to retain any interest in the real property and/or revenues produced by the real property that will ultimately pass to the children, he/she/they may want to consider an outright gift of the property to the child/children that is completed before February 15, 2021, thereby preserving the transferor's base year value for real property tax purposes. To the extent that the fair market value of the real property to be gifted is equal to or less than the "applicable exclusion amount" (i.e. the maximum amount that can pass free of gift and estate tax) available to the transferor, there will be no taxes due as a result of such a transfer. NOTE: the applicable exclusion amount for 2021 is currently $11,700,000 per person, but the Biden agenda calls for legislation that will dramatically reduce the applicable exclusion amount and increase the marginal rates for estate and gift tax, which if introduced and passed this year, may be retroactive to January 1, 2021.

Concerns:

(a) Maturity/Responsibility of Child/Children: The proposed transferees may be too young, too immature or too inexperienced to properly handle the ownership, operation and management of the property to be transferred and/or may be suffering from alcohol or substance abuse issues, making the transfer of an outright ownership interest inappropriate or unadvisable.

(b) Basis Step-Up: If the property is transferred from the transferor-parent to the child by gift, the child's basis for purposes of reporting gain on the ultimate sale of that property will be limited to a "carry-over basis" (namely, the basis of the transferor-parent) plus any gift taxes actually paid as a result of that transfer. If that property is held by the transferor-parent until his or her death and then transferred to the child, the child will receive a "step-up" in basis of that property equal to its fair market value on the date of death of the transferor-parent. This is an important planning consideration, since the elimination of a step-up in basis and the income tax that would be due and payable on the capital gains realized by the child when the property is sold may more than outweigh the real property tax savings, especially if the property is not going to be retained by the child/children for any substantial period of time after the transfer is completed.

(c) Lender Restrictions: The property that would be transferred from the transferor-parent to the child may be subject to a mortgage or deed of trust that includes a "Due on Sale" clause that would be triggered as a result of the transfer, thereby causing the principal balance plus all accrued but unpaid interest due on the loan to become immediately due and payable in full.

(d) Financial Needs of Parent-Transferor: The parent will lose the income produced by the transferred property and the ability to sell such property and retain the proceeds realized from that sale for their personal use and needs. Therefore, the current and reasonably projected future financial needs of the transferor-parent, the health status of the transferor-parent and the life-expectancy of the transferor parent should be carefully considered before implementing such a plan.

(e) Gift Tax Reporting Requirements: On or before April 15, 2022, subject to extension, each parent-transferor will be required to prepare and file a gift tax return (IRS Form 709) to report the transfer of the real property, which must include a qualified appraisal, prepared by a qualified real property appraiser, to establish the fair market of the transferred property on the effective date of the transfer. Our firm can assist you with the location of a suitable appraiser and the preparation and filing of IRS Form 709.

(2) Sale to Intentionally Defective Grantor Trust ("IDGT"): The transferor-parent may want to avoid gift and estate taxes by "selling" the real property to a special irrevocable trust, called an "intentionally defective grantor trust" or "IDGT", for full and adequate consideration in money or money's worth. Under current applicable federal tax law, the transfer of the real property to the IDGT will be treated as a completed transfer for federal gift tax purposes and the IDGT will not be not treated as if it is "owned" by the transferor for estate tax purposes but will be treated as "owned" by the grantor (creator) for income tax reporting purposes. In addition, the transfer of the real property to the IDGT will be treated as a transfer for real property tax purposes, to which the parent-child exemption may be applied if the sole vested beneficiaries of that trust are the children of the transferor.

Assuming all of the current and vested beneficiaries of the IDGT are children of the transferor, the transferor-parent could "sell" the property to the IDGT for its current market value in exchange for a down payment of a certain amount, and a Promissory Note for the balance of the purchase price. If properly structured, this transaction would not trigger a gift tax (i.e. the "sale" would be treated as a sale or exchange for full and adequate consideration in money or money's worth), and would not be included in the transferor's gross estate at death since the transferor would not retain any prohibited powers to alter or control the IDGT. Further, since the transferor-parent would be treated as the "owner" of the IDGT for income tax purposes, the "sale" of the real property to that trust would not trigger income tax on the "gain" (i.e. the difference between the transferor-parent's adjusted basis for the property and the sales price). Finally, since the transaction is a sale and not a gift, the IDGT would get a new basis for the property equal to the sales price paid by that trust to the transferor-parent.

Concerns:

(a) Biden Agenda for Tax Law Changes: The Biden agenda calls for legislation that will eliminate or dramatically curtail the ability of an IDGT to accomplish the

gift, estate and income tax savings it current affords, which if introduced and passed this year, may be retroactive to January 1, 2021.

(b) Lender Restrictions: The property that would be transferred from the transferor-parent to the IDGT may be subject to a mortgage or deed of trust that includes a "Due on Sale" clause that would be triggered as a result of the transfer, thereby causing the principal balance plus all accrued but unpaid interest due on the loan to become immediately due and payable in full.

(c) Financial Needs of Parent-Transferor: The parent will lose the income produced by the transferred property and the ability to sell such property and retain the proceeds realized from that sale for their personal use and needs. Therefore, the current and reasonably projected future financial needs of the transferor-parent, the health status of the transferor-parent and the life-expectancy of the transferor parent should be carefully considered before implementing such a plan.

(d) Income Tax Reporting Requirements: The IDGT will be treated as "owned" by the transferor-parent for income tax reporting purposes. Accordingly, all income produced by the transferred property and any gains realized from the sale of assets held in the IDGT will be taxed to the transferor-parent, even though he/she may not and will not be receiving any distributions from that trust. This means that the transferor-parent will need to use other resources to pay the income taxes attributable to the IDGT. However, applicable federal law finds that the payment of these income taxes will not be treated as a taxable gift from the transferor-parent to the beneficiary(ies) of the IDGT.

(3) Transferring Property to an LLC: Special and different rules apply to the transfer of real property to an entity such as a partnership or limited liability company. If real property is transferred by the transferor-parent to an entity and the transferor-parent's equity interest in the entity is the same as his/her ownership interest in the real property to be transferred, that transfer will not trigger a re-assessment. Thereafter, a re-assessment will not be triggered until more than 50% of the ownership interests in the entity change hands. So, for example, if John Doe and Jane Doe, husband and wife, own Farmland as their community property and transfer Farmland to Farmland, LLC in which each holds a 50% membership interest, that transfer will not trigger a reassessment. Further, a reassessment would not be triggered at the death of the first to die of Jane and John Doe since not more than 50% of the membership interests will change hands. However, a reassessment will be triggered following the death of the survivor of Jane and John Doe.

Concerns:

(a) No Spousal or Parent-Child Exemptions Apply: The special rules applicable to transfers to entities, as summarized above, are the only rules applicable to re-

assessments of real property transferred to/from entities and/or changes of ownership interests within the entity. You may not also apply the spousal exemption and/or parent-child exemption.

(b) Lender Restrictions: The property that would be transferred from the transferor-parent to the LLC may be subject to a mortgage or deed of trust that includes a “Due on Sale” clause that would be triggered as a result of the transfer, thereby causing the principal balance plus all accrued but unpaid interest due on the loan to become immediately due and payable in full.

(c) Business Purpose: Entities such as a partnership or LLC will only be recognized to the extent they have a valid business purpose. Accordingly, a primary residence is not a suitable or appropriate property to transfer to an LLC; it should own only commercial real property used in the conduct of a trade or business.

(d) Income Tax Reporting Requirements: An LLC is treated like a partnership for income tax reporting purposes. It must prepare and file entity informational returns (IRS Form 1065), must attach a Schedule K-1 to the IRS Form 1065 for each member of the LLC, reporting his/her share of income, gains, loss, deduction and credit related to the activities of the LLC and must deliver a copy of the Schedule K-1 to each member. Special new rules have been developed by the IRS for purposes of selecting a "Partnership Representative", who must deal with IRS in audits and must assure that all members report taxable items of the LLC consistently with the IRS settlement, and determining the persons responsible for the payment of any assessments. Our firm can advice you and your accountant in connection with the preparation and filing of IRS Form 1065 and the manner in which the Partnership Representative must deal with the IRS and the other members of the LLC.

(e) Formation of LLC: Most clients do not have an existing entity such as a partnership or LLC, which can serve as a vehicle to own and operate commercial real property. Our firm can assist you with the paperwork required to create an LLC.

The last day to file a request for the parent/child exclusion with a California County’s Assessor/Recorders Office is February 12, 2021. Due to the prediction of high volume requests, we recommend contacting our firm as soon as possible to discuss your specific estate planning needs.

Please contact the Ann C. Harris, Principal and Supervising Attorney at, harris@annharrislaw.com, or Alexandra (Alex) Reeves, Associate Attorney at, alex@annharrislaw.com. You may also contact our office directly to set up a conference call at (760) 431-9900.

This article is not legal advice, but a newsletter that explains the effects of Proposition 19, and should not be used to make legal decisions. Please contact our firm to discuss the effects of Proposition 19 on your specific situation.