Limited Time Before New California Proposition 19 Tax Rules Apply

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In this article, Wood and Brown look at California's Proposition 13 and Proposition 19 and explore actions before the looming property tax deadline.

If you own California real estate, you pay property taxes. And like just about all California taxes, they can be high. With residential property, how much you pay is based on your base-year value under Proposition 13, the revolutionary tax law that swept into California in 1978. Unless you have owned your property since the late 1970s, your base-year value is probably your purchase price.

Just the Basics

The decades-old Prop. 13 allows for modest (less than 2 percent) increases in properties' assessed value each year. As a result, property owners' assessed values for property tax purposes are usually somewhat higher than their original base values. Still, because annual increases are capped at 2 percent, Prop. 13 keeps many California property owners' assessed values well below the fair market values of their homes or other real estate. This is particularly true in areas of California where real estate prices have skyrocketed over the last 30 years. That includes large swaths of the Bay Area, Orange County, and the Los Angeles region where a large portion of Californians call home.

Importantly, Prop. 13 limits reassessment only while the same owner owns the property. If the property is transferred or sold to a new owner (and an exception does not apply), the new owner's base value is the *current* FMV of the home, not the previous owner's assessed value. Particularly for properties that were owned for a significant period, this can result in *massive* increases in assessed value. In the Bay Area, it is not uncommon for properties purchased decades ago with Prop. 13-protected assessed values around $300,000 to be sold for millions of dollars.

In those instances, the new owners will be paying much, much more in property tax each year than the previous owners for the same property in the same condition. It is therefore unsurprising that California property owners who have Prop. 13-protected assessed values go to great lengths to make sure that nothing they do with their properties inadvertently triggers an FMV reassessment. Property owners also pay close attention to what is *not* considered a change in ownership that will trigger an FMV reassessment.

For example, transferring a property to a living trust for which you are the grantor and beneficiary is generally considered *not* to be a transfer for reassessment purposes. A living trust is not a separate taxpayer, so a property owner can usually put a living trust in place for estate planning purposes and transfer a home to the trust without losing the Prop. 13-protected assessed value. But apart from this simple situation, any transfer is sensitive and worthy of caution.

Under Prop. 13, your county assessor can increase your bill slightly every year, even if the home's market value increases much more. They can also add value and more taxes if you remodel your house, add a room, and so forth. Still, your base-year value is worth something, often quite a lot. It's the gift that keeps on giving too, since a property tax bill comes every single year. So if you or your family might own the property for decades, that adds up.

Besides, the way real estate prices keep climbing, including during the pandemic(!), even if you bought your property only a few years ago, the value might be significantly higher now. Whether you have children living with you or not, how about handing a tax benefit to your kids? If you can transfer your property to your children now or on your death and keep your low property tax basis, you want to, correct? That's where our story begins.

Proposition 13, Meet Proposition 19

California's Proposition 19 passed during the wild and protracted November 2020 election, and was arguably one of the more complex propositions. Most people were focused on the nail-biter presidential election. But there were plenty of smaller and local issues too. California, long known for a complex and voluminous bunch of propositions, had plenty of them. Sometimes they are hard for many of us to understand.

It can even be difficult to determine whether you are voting for something or against it. Is a yes really a no, or is a no really a yes? Some of the propositions can be real head-scratchers. Prop. 19 has two major provisions: one that helps taxpayers to avoid triggering a reassessment, and another that limits an existing exception to reassessment, making it more likely that a transfer will result in a property tax reassessment. Let's look first at the positive and helpful part of Prop. 19. This was the one that seemed to get the press before the election, so that's probably why it passed.

Helpful Change

First, the pre-Prop. 19 rule. Homeowners who are 55 and older have had a one-time opportunity to retain their existing property tax basis if they sell their existing home to purchase another home of equal or lesser value — either within the same county or in other eligible counties. This rule is not going away, and in fact, is getting a little better.

Starting April 1, Prop. 19 allows homeowners 55 and older, homeowners with severe disabilities, and homeowners whose residences have been substantially damaged by wildfires or natural disasters to preserve the original property tax basis from their current home when purchasing another home in California.

What's more, the location of the new property, and its value, will be irrelevant starting April 1. The new property still must be your primary residence, but it is a more liberal set of rules.

You can even use this rule up to three times, each time claiming the low-tax benefit. And there's a two-year allowance too. You have up to two years to sell your home and buy a new one. So if you want to take advantage of this provision, it suggests waiting until April 1. The benefit is not automatic, though. Each time you use this one, you must file a claim with your county assessor's office.

Costly Change

To offset the lost revenue from this first provision, Prop. 19 contained a second major change to the property tax provisions that is less beneficial for property owners. The second provision cuts back on your ability to pass property to your kids and grandkids without triggering a reassessment. The new regime kicks in February 16, a different, earlier effective date than Prop. 19's other major change.

To understand these changes, let's first look at what the current rules are. In 1986, less than 10 years after the Prop. 13 revolution, California added Proposition 58 to exclude from reassessment some transfers of real property between parents and children. The transfers of real property protected by Prop. 58 are (1) a transfer of a parent's principal residence (no matter how valuable it might be); and (2) a transfer of the first $1 million of real property *other* than a primary residence.

The $1 million exclusion applies separately, so a married couple could really transfer $2 million. Finally, the $1 million figure is based on the factored base-year value (that is, the assessed value), not the FMV. These are the rules that are still in place for transfers before February 16. But on or after February 16, a new, more limited set of rules applies.

Should you transfer before February 16? The old rules, which are still in effect until February 16, allow some planning. The big danger in Prop. 19 is that it eliminates your ability to pass your home to your kids (or, in some cases, grandkids) and to also pass along your low property tax basis for anything *other* than your transfer of your primary residence. Even if you are transferring your primary residence, Prop. 19 makes those transfers subject to the $1 million limit that previously applied only to vacation homes, investment properties, and other properties not used as your primary residence.

Before Prop. 19, within the limits noted above, you could get the property tax benefit and keep the property for your kids (or, in some cases, grandkids), even if you had commercial property. You might have a store, rental house, flat, or a big apartment building. How commercial properties are taxed under Prop. 13 is more complicated than with residences, as there are ways the county assessor can increase your bill. Even so, your historical basis is still worth a lot.

Starting February 16 there are big limitations on your ability to pass along your assessed value to your kids or grandkids. Once the new rule kicks in, you can no longer transfer your tax basis on your primary residence unless the property is used by your kid or grandkid as a primary residence.

Caution

The language in Prop. 19 requires that the property must have been used by *both* the transferor (the parent) and the transferee (the child) as their primary residence to preserve the assessed value (or at least to preserve up to $1 million of it). The language in Prop. 19 provides:

> For purposes of subdivision (a) of Section 2, the terms "purchased" and "change in ownership" do not include the purchase or transfer *of a family home of the transferor* in the case of a transfer between parents and their children . . . *if the property continues as the family home of the transferee*. . . . "Family home" has the same meaning as "principal residence." [Emphasis added.]

Therefore, if the property you are transferring to your kids is not your primary residence, *or* if it will not be your kids' primary residence, the property is subject to a market value reassessment. Even if it is a primary residence in both the parents' and children's hands, it will soon be subject to the $1 million limit.

Currently, the law says that property transfers of parents' primary residence between parents and children are not considered a change in ownership. That means these transfers are excluded from property tax reassessment, regardless of how the kids use the property. The children might use it as a primary residence, a vacation home, rental property, or even use it in a business.

And the current parent-to-child rule covers grandkids too. It applies to property inherited by grandchildren from their grandparents when both parents are deceased, as well as the later inheritance of the same property by the next generation. The new rules also retain this rule for transfer to grandchildren, albeit now only relevant to transfers of primary residences.

In short, Prop. 19 has slashed your ability to keep a lower property tax basis for anything other than a primary residence that your kids or grandkids themselves keep using as their primary residence. Even then, the benefit applies only to a limited amount of your assessed value, unlike current law. The rules allow you to make transfers now before the February 16 effective date for the new rules.

Careful Planning?

Of course, it can be dangerous to plan around one tax consideration without taking into account other potential tax (and nontax) consequences. Although transferring investment property to your children before February 16 may be attractive for being able to pass along your lower assessed values for property tax purposes, it may not be advantageous for income tax purposes. By transferring the property while you are alive (as a gift), your children would generally receive a carryover tax basis in the property, which may result in significant capital gains for them if they later sell the property.

If, however, you retain the property until your death, assuming there are no major changes in tax law between now and then, your children may inherit the property with a new tax basis for income tax purposes equal to the property's FMV as of your date of death (or thereabouts if your estate makes specific tax elections). That can shield a lot of capital gain for them if they later sell the property. Therefore, if you plan to transfer your property through simple gifting, you appear to be stuck with a choice between your children owing more property tax year to year or owing more capital gains tax when they eventually sell the property.

Unsurprisingly, good tax planning can help. More sophisticated structures, including transferring or selling the property to some types of trusts, may help taxpayers achieve both lower property tax values and lower capital gains for their children. These structures should also consider gift and estate tax implications, too, as well as nontax considerations, particularly if you rely on the rental income from the properties for your living expenses.

Last Word?

However, good planning often takes some time and careful consideration. Yet with the deadline, property owners (and their advisers) may be frantically scrambling to see what sort of planning is right for them and to try to implement those plans, all before February 16. That is generally not a tasty recipe for good, nuanced decision-making.

Can we expect disputes with assessors in future years, and maybe even litigation over these issues in some cases? We would guess so. But in the meantime, there are plenty of California property owners — even if they are young and hardly thinking about estate planning — who might want to look into these rules before it is too late.

Because of the passage of Prop. 19, these tax benefits may be eliminated by imposing a mandatory property tax reassessment for all property that is transferred between parents and children, when the property is no longer used as a primary residence. Remember, on top of all the other stresses during this unsettling time, these new property tax rules regarding parents/child/grandchild transfers are slated to take effect February 16. ■