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PROP 19—THE GOOD, THE BAD, AND THE UGLY

The voters of the State of California recently had two propositions on the ballot related to real property taxes. **Prop 15** would have required commercial and industrial properties not zoned as agriculture to be taxed on their market value, not on their purchase price plus the 2% increase per year under current law (Prop 13 rules). **Prop 15 was defeated** by a 52% to 48% vote.

Prop 19 was the other proposition and it **passed** by a 51.11% to 48.89% margin. A slim margin, but a passing margin, thus making it a constitutional amendment. While the following paragraphs will try to explain the impact of Prop 19, **do not take any action unless you have consulted with your attorney first.**

THE GOOD

Under **old law**, those age 55 or older or those severely disabled of any age could sell their primary residence and if they bought another primary residence in the same county of the same or lesser value as the home sold, they could transfer their assessed property value of the old home to the new home. Thus, no increase in property taxes paid whatsoever. (Note: There were instances where the replacement home could be up to 110% of the sold home and there were a few rare counties that would accept the transfer from an outside county.)

Example under old law: Homer and Marge Simpson had a large 5-bedroom house in Sonoma County at 742 Evergreen Terrace. Since they purchased the home many, many years ago, their assessed value under Prop 13 was only $275,000 and they were paying about $3000 a year in property taxes. Since the children were all grown up, they decided the house was too large for them and sold it for $950,000. The $600,000 condo on the other side of town was perfect. Instead of paying around $7000 in property taxes on their new condo, they could take their $275,000 assessed value with them to the new home, thus saving themselves over $4000 per year.

Under **NEW LAW,** starting April 1, 2021, a person age 55 or older or severely disabled of any age can sell their primary residence and transfer their property tax assessment to any other property within the State of California (not just within the same county) and take their assessed property value with them. In addition, they can do this up to 3 times (not just once). In addition, if they purchase a new primary residence for more than they sold their former primary residence, only the difference will be added to their assessed value.

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Example under new law: Same example as above but Homer and Marge buy a small, one-bedroom condo on the shores of Malibu (Los Angeles County) for $1,250,000. Not only can the Simpsons transfer their assessed value to a different county, but instead of paying around $14,000 a year in property taxes on an assessed value of the purchase price, their assessment will only rise $300,000 (the difference between the purchase price of new primary home and sale price of prior primary residence) thus paying property taxes of around $6,000 per year. When Homer heard about this he uttered "Doh, that's a lot of donuts."

THE BAD (OR NOT SO GOOD)—Primary residence transfer
Under **old law**, parents could transfer the assessed value of their **primary residence** of any value to their children and the children could keep the assessed value. This usually happened at death and the children could use their parents' former primary residence anyway they wanted--as a primary residence, a rental property, or as a vacation home. It didn't matter.

Under **NEW LAW**, starting February 16, 2021, the assessed value of a parent's primary residence can only transfer to a child **IF** the child then uses the home as their primary residence. **In addition,** if the difference between the fair market value of the primary residence and the assessed value exceeds $1 million, the excess over $1 million gets added to the assessed value.

Example under new law: Homer and Marge Simpson still own their 5-bedroom home when they both die. Bart inherits the home and will use it as his primary residence. Bart keeps the $275,000 of assessed value and continues to pay the low property taxes. But, if the home is worth $1,500,000, that exceeds the assessed value by $1,225,000. Thus, Bart's assessed value for property taxes will increase by $225,000 (the difference that exceeds $1M) and his new assessed value will be $500,000. He will be paying around $6000 in property taxes. Still not bad, but not as good as before Prop 19. (As a side note, starting in 2023, the $1M limit is increased by the change in the HPI, or House Price Index).

A FEW QUESTIONS ARISE:
What if Bart doesn't use the home as his primary residence, but as a rental or a vacation home? Answer: See **THE UGLY** below.

How long does Bart need to keep the home as his primary residence? One year, two years, forever? Answer: The Proposition does not address this and will need to be clarified. Please consult your attorney.

What if all three of the Simpson's children inherit the home? Do all three have to use it as their primary residence or only one of them? Answer: The language of Prop 19 doesn't address this. Further guidance from either the Legislature or assessor analysis is needed to clarify the issue. Please consult your attorney.

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THE UGLY

Under **old law**, each parent could transfer up to $1M of "assessed value" (not FMV but assessed value) to a child of any other real property in California (vacation homes, rentals, etc.) and the child would keep the assessed value.

Under **NEW LAW**, all real property transfers on or after February 16, 2021 that aren't the primary resident of the parent prior to transfer and won't be the primary residence of the child after transfer, are reassessed at fair market value, period, no exceptions, final.

Example under old law: Homer and Marge had a vacation home in the California mountains next to a small town with a great burger/donut/beer pub called Duff's Pub. They paid $150,000 for it in 2005. Homer and Marge died in 2022 when the vacation home was worth $800,000 and it has an assessed value of $210,000 in 2022 due to the 2% increase allowed under Prop 13. Currently the property taxes are around $2500 per year. The Simpson's children could keep the vacation home and the low assessed value of $210,000.

Example under new law: If the children decide to keep the home after their parents' death in 2022 it will be reassessed for property tax purposes at $800,000 and they will pay around $9,000 a year in property taxes, an increase of about $6,500 every year.

THIS RAISES A FEW QUESTIONS (THAT WOULD NEED TO BE DISCUSSED WITH YOUR ATTORNEY AND TAX ACCOUNTANT)

Should I transfer my rentals and vacation homes to my children now, prior to February 16, 2021? Answer: This update cannot address that, and that answer should be part of your overall estate/transfer plan discussed with your attorney. But a few factors to consider (and there are more, so this is not an all-inclusive list):

1) If you transfer the properties now to your children, this creates a gift and will reduce your estate exclusion when you die. Depending on the laws at the time, this could create a taxable estate.

2) You give up the rights and controls of those properties. That means you give up the rental income. In addition, your children can then sell, borrow against, or even paint the property purple and green if they want. You have no control.

3) If you transfer the properties to your children prior to your death, they keep your income tax basis and won't get a "step-up" at your death. If they sell the properties, they will incur capital gains as if you sold it as they will have your income tax basis.

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Can I transfer my properties to a legal entity, such as an LLC or Limited Partnership, have the entity own them, transfer ownership of the entity to my children at my death, and keep the low property tax assessment? Answer: You guessed it, please consult your attorney.

What should I do then?
Discuss this with your spouse (if married) and your estate planning attorney. There are many smart minds trying to come up with plans to get the best of both worlds, low property tax assessments and a large income tax basis, while allowing the current owners to have control over their properties in California. Much of that is a legal discussion, not a simple tax discussion, and thus needs to be addressed by your attorney as well as your tax accountant.