

Real Estate Transfers Between Parents and Children Are Likely to See Higher Property Taxes Starting in February 2021



By Sean M. Finerty

In just a few weeks, Proposition 19 will take effect in California – and with it, some of the most significant changes to the state’s property tax laws in nearly 35 years. In particular, the new law eliminates many of the tax protections that, for decades, had been afforded to transfers between parents and children, and grandparents and grandchildren. As a result, future generations may be burdened with unexpected and substantial increases in annual property taxes if they transfer property after Proposition 19 takes effect on February 16, 2021.

First, to better appreciate the impact of Proposition 19, it helps to understand the laws that are changing. In 1986, California voters approved Proposition 58, which amended the state constitution to exclude from tax reassessment certain transfers of real property between parents and children. This exclusion applied to transfers of the transferor’s primary residence, plus any additional properties that have combined assessed values of \$1 million. Nearly 10 years later, voters approved Proposition 193, which afforded the same protections to qualifying transfers between grandparents and grandchildren.

To use an example, Peter and Kate own a modest investment property in Santa Monica currently worth about \$2 million. They purchased the property 30 years ago, and, thanks to Proposition 13 (which limits increases to taxable value at just 2% per year), the property’s taxable value is just \$250,000 – Peter and Kate’s annual property tax bill is about \$3,000. If Peter and Kate were to sell the property, however, the property’s taxable value would be reassessed at its current fair market value (i.e., \$2 million), in which case the property taxes would increase significantly for the new owner – where Peter and Kate were paying about \$3,000 per year in property taxes, the new owner will be paying closer to \$24,000 per year. But rather than sell the property, Peter and Kate would prefer that the property stay within the family and have decided to gift the property now to their son, Kevin. Because of the protections previously afforded by Proposition 58, this transfer would be excluded from reassessment. In other words, the property’s

taxable value will remain at \$250,000, and Kevin's annual property tax bill will be the same \$3,000 per year that his parents were paying.

Under Proposition 19, however, these protections will soon be history. Proposition 19 amends the state constitution so that transfers between parents and children (and grandparents and grandchildren) are excluded from reassessment only if (a) the property was the transferor's principal residence immediately prior to transfer, and (b) the transferee intends to reside in the property as the transferee's principal residence following transfer. Proposition 19 completely eliminates protections previously afforded to other properties, such as commercial properties, vacation homes, and other income or investment properties. Therefore, using our example above, under Proposition 19, Peter and Kate's transfer of their commercial property to Kevin will no longer qualify for an exclusion from reassessment. Consequently, Kevin's annual property taxes will be based on the property's current market value of \$2 million, and thus will increase to about \$24,000 per year – an 8x increase over the property taxes his parents were paying.

But the changes brought by Proposition 19 don't end there. Under the current rules of Proposition 58 and 193, the transfer of the transferor's principal residence to a parent or child (or grandparent or grandchild) is excluded from reassessment, regardless of the transferee's intended use of the property, and regardless of the property's value. Proposition 19, however, requires that the property be used as the transferee's principal residence, and further limits the amount of the exclusion to the property's taxable value plus \$1 million. In other words, if Peter and Kate's principal residence has (a) a taxable value of \$500,000, and (b) a current fair market value of \$2 million, then, under Proposition 19, any transfer of that property to Kate will be excluded up to the first \$1.5 million in value, and the remaining \$500,000 in value will be reassessed at the property's current market value (provided, of course, Kevin intends to use the house as his principal residence).

So, should Peter and Kate sprint to the County Recorder's office to transfer title to Kevin before Proposition 19 takes effect? Not necessarily. If Kevin does not intend to hold the property, but rather intends to sell it, then, from a tax standpoint, Kevin may be better off if Peter and Kate were to hold the property until they both pass away. Kevin would then inherit the property with a stepped-up income tax basis. That is, if the property is worth \$2 million when Kevin inherits it after his parents pass away, then his income tax basis in the property is \$2 million; if Kevin were to then sell the property for \$2 million (i.e., equal to his income tax basis), then he pays nothing in capital gains taxes. However, on the other hand, if Kevin were to receive the property during Peter and Kate's lifetime, then he would take the property subject to Peter and Kate's basis in the property. If, for example, that basis is \$100,000, and if Kevin were to then sell the property for \$2 million, then he pays capital gains taxes based on the \$1.9 million difference. The capital gains tax rate depends on Kevin's tax bracket, but if we were to assume 20%, then the tax bill comes to \$380,000. In short, the question as to whether property should be transferred before Proposition 19 takes effect depends largely on the intended future use of the property – if the property will be held for the long-term, then the benefits of lower property taxes may outweigh the loss of a stepped-up income tax basis, in which case the property should be transferred before Proposition 19 takes effect; however, if the receiving party has no desire to keep the property but would instead sell it, then the better choice is likely to hold the property until death, at which time the receiving party takes a stepped-up basis and better capital gains treatment.

Proposition 19 is not the law today, but it will be in just a few weeks. These new rules affecting transfers between parents and children, and grandparents and grandchildren, will take effect on February 16, 2021. Therefore, property transfers that would benefit most from existing law should be completed before that date.

If you have any questions about Proposition 19, or if you would like to transfer your property before Proposition 19 takes effect, please contact Sean M. Finerty at The Alvarez Firm, at (818) 224-7077, or by email at sfinerty@alvarezfirm.com.