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Cutbacks to the Parent-Child Exclusion from Property Tax Reassessment Under Proposition 19

Family Wealth Planning Group

With the passage of Proposition 19, California voters significantly limited the ability of parents to transfer California real property to their children without a reassessment for property tax purposes. The new law will not take effect until February 16, 2021, but given the holidays on February 12 and 15, all transfers should be recorded on or before February 11.

This alert provides an overview of the changes, which may impact your estate planning.

1. Current Intergenerational Property Tax Exclusions (Until February 16, 2021)

In 1978, California voters enacted Proposition 13, providing (among other things) a new system governing the taxation of California real property. Prior to Proposition 13, real property values were reassessed annually, and the tax rate was applied to this fair market value to determine the property tax due. Proposition 13 mandated that real properties be taxed at 1% of their *factored or adjusted base year value*.¹ The *base year value* of a property equals its fair market value as of the 1975-1976 tax year, or at the time of a subsequent change of ownership or new construction. *Factored or adjusted base year value* is the property's base year value increased for inflation, but only up to 2% per year.²

Under the original law, property was reassessed when it was inherited by children. Given the steep increase in California real property values, children were often unable to afford to pay the property tax on the fair market value of family homes. To combat this, voters passed Proposition 58 in 1986, which established the "parent-child exclusion" from reassessment for certain real properties transferred between parents and their children. The exclusion from reassessment applied (and continues to apply before February 16, 2021) only to the extent that certain claim procedures are followed and one of the following requirements is met:

- The transferred property is the principal residence of the transferring parent (this exclusion is unlimited as to value)³; or

¹ Certain real properties can qualify for special valuation treatment, such as farms under a Williamson Act agreement. Additionally, property fair market value, if lower than factored base year value, will instead be used. See Proposition 8, November 1978, codified at RTC §51(a)(2).

² The inflation factor can in fact dip below 2%, but can go no higher. RTC §51(a)(1).

³ The exclusion also applies for transfers from children to parents.

- If the transferred property is not the principal residence of the transferring parent, then only when the transferring parent has excluded cumulatively no more than \$1,000,000 worth of factored base year value (assessed value) of non-principal-residence real property.

Proposition 193 extended the protections of Proposition 58 to grandparent-grandchild transfers in very limited circumstances not addressed here.

2. Change in the Law Effective February 16, 2021

In lieu of the foregoing rules, under Proposition 19, properties other than a family home (principal residence) will lose their protection from reassessment completely. The parent-child exclusion⁴ will still protect family homes, but only if the child uses the home as a principal residence (and claims a homeowner's exemption or disabled veteran's exemption).

A family home will escape reassessment entirely only if the property's fair market value does not exceed \$1,000,000 over the factored base year value (with this \$1,000,000 increased periodically for inflation). If the family home is worth more than this amount, then up to \$1,000,000 in the value of the home exceeding the factored base year value will be taxed at the old adjusted base year value, and the rest will be reassessed. Effectively, this means that the parent-child exclusion will not provide more than a \$10,000 annual tax benefit to children.

For example, if the factored base year value of a parent's home is \$500,000, and the home is worth \$1,499,000 at the time the home is transferred to the child, then there will be no reassessment at all, if the child uses the home as a principal residence. If the home is worth \$5,000,000, then the first \$1,500,000 will be protected from reassessment while the remaining \$3,500,000 will not, resulting in a new factored base year value of \$4,000,000.

Thus, the new law significantly contracts the availability of the intergenerational exclusions for California real property. Non-principal residences will completely lose their protection from reassessment, and principal residences in any expensive market will lose much of their protection from reassessment.

Proposition 19 provides taxpayers with a small window of time to react to these changes: These cutbacks become effective February 16, 2021, with the current more favorable rules governing until such time. Any transfers made with the goal of avoiding reassessment should be recorded on or before February 11, due to the holidays on February 12 and 15.

3. Conclusion

The upcoming implementation of Proposition 19 marks a significant change in how wealth planners will optimize for California's real property tax reassessment rules with intergenerational transfers. However, planning options may still be available before the February 16, 2021 effective date.

⁴ The same rule also applies to transfers between grandparents and grandchildren where the intervening generation of parents (including step parents) have died.

For information on how to best create an estate plan that works for you, taking into account the changes under Proposition 19, please contact any member of the Shartsis Friese Family Wealth Planning group.

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