



## **Proposition 19 Estate Planning Considerations**

**PLEASE NOTE:** This statement is for informational purposes only and may not be applicable to your specific situation; it is not intended as legal advice and we are not tax advisors. It is a general summary of law only and may not include legal issues or considerations specific to your family. As most of our clients are not subject to federal inheritance tax on their estates, those issues are not discussed. Please note, *as of February 1, 2021, Summerall Law is no longer offering consultations or services related to Prop 19.*

**This article highlights some of the key issues your family should consider in thinking about whether you should change your estate plan in light of Proposition 19 (“Prop 19”) being approved by voters.**

### **Intro:**

We have been getting a lot of questions about Prop 19 and **we understand that clients are concerned about “missing” the opportunity to take advantage of the old property tax calculation rules** on real estate a parent is transferring to their child before the rules change on February 15, 2021.

- Prop 19 is a change to the law that was recently approved by voters.
- It concerns the amount of annual property tax that a child will pay on real estate *after* that real estate is inherited from a parent; **in short, it makes it more likely that property taxes will go up** after a child inherits real estate from a parent.
- In certain circumstances property passing from a parent to a grandchild is also subject to these rules. (Prop 19 also changed other tax rules that we are not discussing here.)

Many articles that report on Prop 19 state that Prop 19 will make it more expensive for families to keep inherited real estate. While that is true in some cases, Prop 19 is only about property taxes and **property taxes are not the only important issue to think about when considering transferring property from a parent to a child.** Other key issues – like how a transfer changes the capital gains tax that may be due on a property if sold and how a transfer impacts the parent – are also very important to consider.

**For the majority of our clients, we believe trying to take advantage of the old rules will actually result in real estate being less valuable to children and presents risk to parents because it would require the parent (or parents) to give up control of their real estate now.** Our thoughts are detailed below.

### **Why Advising on Prop 19 is Hard:**

We wish that it was easy to advise clients on what to do about their property and estate plans in light of Prop 19. It isn't. It is actually pretty difficult to advise clients about what the “right” thing to do is.

To know whether it will be better for your family for the parent to give property to the child now (to take advantage of the old rule) vs. the parent keeping the property and allowing the new rule to apply, we would have to correctly predict the answer to some tough questions. Specifically, **we would have to be able to guess the right answer to each of these questions:**

1. When will both parents pass away? (5 years from now? 10?)
2. How much will the value of the property change between now and then?
3. How long will the child who inherits want to live in the property after the parents pass away?
4. Will this tax rule or others change between now and then?



Predicting the future is hard. In our experience, many people guess the wrong answers to these questions.

### **What We Recommend:**

What we recommend is that families start with a family conversation about the factors highlighted below. This will often help the family come to an answer about what they want to do without the need to pay for legal advice.

***If, after considering this information, you are still interested in consulting with an attorney, you should act quickly before the February 15, 2021 deadline.***

Unfortunately, as of February 1, 2021, ***Summerall Law is no longer offering consultations or services related to Prop 19.*** There is not enough time before the deadline for Summerall Law to take on any additional Prop 19 matters or to offer any consultations on these issues given our commitments to existing clients.

If you do not want legal advice about what to do, and just want someone to prepare deeds for you now, you can work with a company like California Document Preparers. One of their representatives that our clients have enjoyed working with in the past is Ian M. Duncan ([www.cadocpreparers.com](http://www.cadocpreparers.com)) (510) 452-2320).

### **Key Issues to Consider**

Below is a list of key issues to think about. An introduction to each one is detailed in its own section below.

1. How does Prop 19 change the rules on property tax?
2. Does the parent want to give their real estate away now?
3. Does the child want gifted property when that often greatly decreases the value of the property by increasing the capital gains tax due when the property is sold? (“The Capital Gains Problem”)
4. Is the child going to keep or sell the inherited real estate?

### **1. How Does Prop 19 Change the Rules?**

Prop 19 concerns to what extent the annual property tax bill on a property will change when a parent transfers that property to their child (or their grandchild if the parent of the grandchild has passed away).

#### **Property Tax Intro:**

- The amount of property tax you pay is based on the **purchase price** of the property plus the cost of improvements – this is called the **assessed value**. Unless the property changes owners, property taxes do not increase by more than 2% per year.
- When real estate changes owners (whether because of sale or inheritance or gift, etc.) – unless an “exemption” applies—the assessed value is “reassessed” to the current market value.



- Because CA real estate has gone up in value quickly, if the property has been owned for a significant period of time, the reassessed value is typically much higher and property taxes increase.
  - For example, if a brother inherits a house that his sister had owned for 20 years, the property tax bill could increase from \$2,000 per year to \$20,000 per year because the assessed value of the home will have gone up so significantly. (This is a general example.)

#### **The “old” rule – when a child inherits real estate, property tax is not likely to go up**

- Under the “old” (applicable until Feb 2021) rule, there are two valuable exemptions from reassessment – an exemption from reassessment typically means the new owner keeps the old owner’s property tax assessed value. These exemptions apply in the following circumstances:
  1. The parent transfers the parent’s **residence** to their child. It doesn’t matter what the child does with the property (live in it, rent it, etc.).
  2. The parent transfers a non-residence to a child: the first \$1 million of assessed value is not reassessed. (Often this means either no increase or a small increase in property tax.)
- These are called “Parent-to-Child exemptions”

#### **The “new” rule – when a child inherits real estate, property tax is likely to go up**

- Prop 19 changes the Parent-to-Child exemptions so that (1) only certain transfers between parents and children are exempted from reassessment, and (2) even if exempted, the property tax benefit is reduced. Beginning February 15, 2021:
  1. Only a transfer of the parent’s **principal residence** to the child where that property **becomes the child’s principal residence** qualifies for the exemption.
    - So, if the child doesn’t live in the home after he or she inherits it, the property is reassessed and the taxes will likely go up.
    - This means if you inherit a rental property or a vacation property (a property the parent did not live in) the property taxes will go up.
  2. For the residence-to-residence transfers, if the property has increased in value by more than \$1 million (comparing the parent’s assessed value to the property value at the time of passing), there will be some property tax increase. The new assessed value will be the current value of the property minus \$1 million.
    - For property that has significantly increased in value there will be a property tax reassessment of some of the property value.

#### **Prop 19 Property Tax Bottom Line**

- **Some people advocate the parent give the child the house now**, so the “old” rules apply and they can avoid the property tax reassessment, meaning the child keeps the parent’s low property taxes.
- **There are, however, significant downsides to trying to use the “old” rule – both for the parent and the child.**



## **2. Does the Parent Want to Give Away Their Real Estate?**

To take advantage of the “old” property tax rule, generally the parent would give their real estate (or at least a portion of it) to their child now. But, most people should not give away their real estate.

- If a parent gives their child real estate to try and reduce the child’s property taxes in the future the parent is giving up control of that real estate. **That is a decision with enormous consequences.**
- For most parents, real estate is a valuable asset that they need to keep control over for the rest of their life. Giving away real estate means you can no longer do any of the following:
  - sell it and move to a smaller home or a different town,
  - take a loan against it to have more spending money, or
  - decide to leave the home to someone else (for example, a grandchild or a child who falls on hard times and needs it more).
- It also means all of the following could happen, and there is nothing the parent could do to stop it:
  - child can take a loan against the home, or
  - if the child has debt, that debt could be enforced against the parent’s (now the child’s) home – for example, in the event of divorce, child support, or a car accident.
- Gifting real estate will also likely cause the parent to be required to file a gift tax return, which can have inheritance tax consequences.
- If a parent transfers real estate to a child at a time when the parent has debts, that does not avoid the debts, the house can still be seized by creditors. (Unlikely but possible).

## **3. Does the Child Want Gifted Property? “The Capital Gains Problem”**

For the child, receiving gifted property that the child is likely to sell within a reasonably short time will greatly decrease the overall value of the property by increasing the capital gains tax that will be due when the property is later sold.

**Capital gains tax considerations are essential to considering whether gifting property will actually be best for the child financially.** Here’s why:

- On property that you own for more than a year that increases in value, you have to pay taxes on the increase in value (your “capital gain”) when you sell.
- How capital gain/increase is calculated on property that you give to a child during your lifetime versus property a child inherits from you is very different because of the “step-up” rule.
  - To calculate your “gain” on property you look at the value on the date it is sold (the sales price typically) and compare that to the purchase price. The purchase price is called your “basis.” You pay tax on the gain.
  - That means the bigger the difference between the sales price and the basis the more tax is due. The higher the basis the lower the capital gain. So, a higher basis is better.
  - When a child inherits your property, the basis is “stepped-up” to the value on the date the parent passed away. That means the new basis and the new value are typically very close, which means no capital gains tax. This makes the property more valuable to the child.
  - **If you give your child your property during your lifetime, they get your basis and no step-up if you pass away.**



- Consider 2 different scenarios on a home that a parent purchased for \$200,000 (that is, the basis is \$200,000) that is worth \$1 million when the parent passes away and is then sold by the child.
  - **Inherit + quick sale = no capital gains tax.** If the parent passes away and the child inherits the house and then sells it, there is **no capital gains tax due** because when the increase is calculated it is calculated based on the value on the date of the ownership change because of the step-up rule. In fact, the child will often have a tax savings because they can treat any closing costs as losses and reduce their regular income taxes.
  - **Gifted property + sale = big capital gains tax bill.** If the parent gifts their home to their child during the parent's lifetime, the child gets the parent's basis and no step-up when the parent passes away. That means if the child is the owner of the home the parent lives in, and then the child sells the home after the parent passes away, the child's capital gain would be \$800,000 and **the tax bill would be \$140,000** using an average rate of 17.5% (rates are 15% to 20% depending on income).
    - **Note, these capital gains tax examples only consider the federal rate, California income tax rates may also apply.**

So, for many children with parents who have homes that have greatly appreciated in value, the opportunity to pay far less in capital gains tax when the home sold is more valuable than a few years of paying less in property tax. Here is an example of how that math works out:

- Taking the example above of the house that went from \$200,000 to \$1 million; the child saved \$140,000 in capital gains tax that they did not have to pay.
- Let's assume the property taxes on that house that the parent paid were \$2,000 per year and under the "new" Prop 19 rule would move up to \$13,000 per year when the child inherits (this is a rough guess for illustrative purposes, it is not based on a specific city's tax rate or home value). So, the child is "losing" \$11,000 per year as compared to what they would pay under the old rule.
- Even if under the "new" property tax rules they had paid that extra \$11,000 for three years, so they "lost" \$33,000, the child still saved the \$140,000 in capital gains tax at the time the home was sold and came out ahead by over \$100,000.

#### **Potential exception:**

If one parent who was a co-owner of the home has passed away, the basis for the surviving parent was likely re-set at that time to the market value on the date that person passed away (this is another example of how the step-up rule works). If that happened, then that may have "erased" much of the capital gain and this analysis would be a bit different for that family.

In this scenario, the property is extra valuable even if gifted because of the "high" basis paired with the low property tax rate. (Property tax rates are not reassessed when a spouse passes away.) This could be an example of the type of property it *might* make sense to gift now to try and take advantage of the old property tax rule. Said another way, because of the property having a high basis, the child in this example would be "giving up" far less in potential capital gains tax savings by accepting the home as a gift.



#### **4. Is the Child Going to Keep or Sell the Inherited Real Estate?**

Many parents assume their children will want to keep the real estate the children inherit from their parent indefinitely. Parents may believe the child or children will rent the property out and profit off it, or that they will want to live there. For children who are going to keep property for a long time, having lower property taxes (trying to use the “old” rules) is more important.

In our experience, **many children quickly sell the property they inherit from parents.** There are a number of reasons for this:

- When multiple children inherit property together, they often do not want to manage property together, or to live together.
- Even if one child wants to keep the home, unless all the children agree it can be difficult to make it work financially because one child has to buy the others out at the new market value.
- Many children prefer to have the more substantial cash from the sale to solve immediate problems in their life – or to take advantage of new opportunities in their life (like a new home or paying for a child’s college tuition) – rather than taking small rental payments over time.

**If children are likely to sell the property fairly quickly, then the opportunity to reduce capital gains tax is far more valuable than reducing the annual property taxes – because the children won’t be the ones paying the higher property taxes.**

**In that scenario, the “new” rules are fine, and the parent should keep the home in their name so the children can benefit from the step-up in basis and the reduction in capital gains taxes after the parent passes.**

**Exception:** Examples of when the child may keep the real estate for a long period of time:

- Rental properties that the children will want to keep as rental properties for multiple years.
- When children already have a home and would want to rent out the parent’s home for a long time.

#### **Summary**

Most people do not need to worry about which Prop 19 rules will apply to their property because one or more of the factors below is true for them:

- The parents need to keep control of their real estate, so gifting now to get the old rules is not an option.
- The children are likely to sell the real estate within a short time, so getting the step-up for capital gains is more important than saving on property taxes that they won’t pay (true because accepting gifted property usually reduces the potential for capital gains tax savings).
- The child is likely to live in the parent’s home and the home has not increased in value by more than \$1 million, so the property taxes will not change even when the child inherits under the new rule.



If a parent does have property that they would consider gifting now (they don't need control of the property), and it is a property the child is likely to want to keep (they aren't selling soon), the family should consider if the benefit of reduced property taxes on an ongoing basis (the benefit of the "new" rule) would outweigh the benefit of the step-up in capital gains (which the child would give up by accepting gifted property now).

- This is where it gets tricky because this is one big math story problem that is specific to each family.
- To sort this out, the family needs to look at what the parent's basis in the property is and compare that number to what the likely sale price would be. That tells you what the capital gain is, then you need to calculate the likely capital gains tax based on the rate applicable to the child's income.
- Then, look at how much the property taxes would be if reassessed vs. not (this is different city by city). That difference is the annual savings per year if you take advantage of the old rule.
- Finally, consider how many years would the child have to keep the property for that property tax savings number to be bigger than the money they would save if they didn't have to pay the capital gains tax bill?

The only people who this math usually works for, and so should arguably do something now, are:

- Parents who have a rental property/second home that they want to give to their child and the child will keep it for so long that the property tax savings are bigger than what they would have paid in capital gains tax.
- Parents who recently purchased property (or who have a high assessed value because one spouse passed away), so the capital gains tax difference for the children is much less because the capital gain will not be as significant.

*And, this all assumes the tax rules don't change again. You could guess right on everything about your property and then California could just raise the property tax or capital gains rates on everyone.*

**Bottom line:**

- **If the parent needs to keep control of their home** – because they want to live there or may need to sell and downsize – then the parent should **do nothing** because it is probably not in their interest to give away their home so that their children will save money.
- If the parent has a **rental property or second home** that the parent wants their children to be able to **continue to rent out or use for a significant period of time, the family could be negatively impacted by this change**. For this family, the property tax savings could outweigh the capital gains tax savings that are never realized if the property is never sold. Consider additional planning.
- **If the children are very likely to sell the property, there is nothing to do now**. This is true because when property is likely to be sold the capital gains tax savings that children will receive when they inherit the property is of utmost importance and the property tax savings won't matter.

As you can see, there are numerous technical concepts here. This explanation is an oversimplification of each of those concepts so you can evaluate the overall impact generally. For families where gifting now might make sense, there may be other options where some portion of the capital gains tax savings could be preserved and some control of the "gifted" home could be maintained.