

WEDNESDAY, OCTOBER 14, 2020

PERSPECTIVE

## Proposition 19: 9 considerations before the November 3 vote

By Yin T. Ho

On Nov. 3, California's electorate will vote on Proposition 19, a constitutional amendment that would substantially restrict property tax benefits for real property inherited by children from parents, while also substantially expanding base-year value transfers of property tax value by persons over 55 and victims of wildfire and natural disasters. This article examines nine key considerations for Prop. 19 as we approach the election.



### 1. It's the Principal that Counts

Under current law, parents can transfer a principal residence of unlimited value to their children without triggering a reassessment (the "principal residence exclusion"). Prop. 19 would impose new

would inherit the \$500,000 adjusted base-year value. In contrast, if Prop. 19 passes, then using the same example, only the first \$1 million of value would be excluded, and the new adjusted base year value of the property would be \$1 million.

**It's no secret that Prop. 19 was inspired by the 'Lebowski Loophole,' a reference to a Los Angeles Times investigation disclosing that actor Jeff Bridges and his siblings inherited a beachfront Malibu home from their parents that they thereafter rented out for \$15,995 per month, though the property tax bill was less than half that.**

qualifications on this exclusion by (1) requiring the child to use the property as the child's own principal residence, and (2) limiting the exclusion to just the first \$1 million of fair market value. For example, assume parents own a home with a fair market value of \$2 million, but because of Prop. 13, it has an adjusted base-year value of just \$500,000. Under current law, parents can transfer the entire home to their children without triggering a reassessment, and their children

### 2. There's No Place like Home

As noted, if Prop. 19 passes, the transferee children are required to use the property as their own principal residence and are required to claim the homeowner's exemption at the time of the transfer, or no later than one year after the date of transfer. In general, the one-year filing period is beneficial considering that the transferee children may need such time to make their own transfer of a principal resi-

dence to their respective children, or to qualify for the IRC Section 121 election, or simply to move. For transfers that vest immediately upon the death of a parent (e.g., for properties held in a trust), it is unclear whether the clock for filing the homeowner's exemption claim starts to run upon the date of death or upon the recording of a deed. Until this ambiguity is clarified, attorneys should assume that the former date controls. Children can file the homeowner's exemption claim at the time of transfer on the preliminary change of ownership report by responding "yes" when asked whether the property is "intended as my principal residence" and providing the date of intended occupancy. As a protective measure, even if the children may not immediately use the property as the principal residence but plan to file the claim within the one-year period, it would seem prudent to respond in the affirmative regardless and to provide an occupancy date not later than one year following execution of the transfer deed.

In some cases, parents gift their principal residence to multiple children, which presents no issue under current law since there's no requirement that the children reside in the property. Under Prop. 19, it is not clear whether such transfer would continue to qualify for the parent-child exclusion, since in most cases, only one child would use the property as their own principal residence. Further guidance from the Legislature or assessor analysis is needed to clarify this issue.

### 3. The "Lebowski Loophole" Does Not Abide

It's no secret that Prop. 19 was inspired by the "Lebowski Loophole," a reference to a Los Angeles

Times investigation disclosing that actor Jeff Bridges and his siblings inherited a beachfront Malibu home from their parents that they thereafter rented out for \$15,995 per month, though the property tax bill was less than half that. Prop. 19 would close the perceived loophole by obligating children to use the property as their own principal residence, thereby preventing any leasing activity. However, Prop. 19 does not specify what happens if or when the property converts to other uses in the future. What then, are the consequences if the transfer initially qualifies for the principal residence exclusion, but is thereafter converted to other uses (e.g., second home, third-party rentals, etc.)? Unfortunately, Prop. 19 contains no guidance, though a similarly proposed but failed constitutional amendment from this past legislative session would have required the property to be reassessed at its fair market value as of the date of the transfer from the parent — not on the date of conversion of uses.

### 4. Decoding "Taxable Value" and "Assessed Value"

Prop. 19 would require assessors to calculate the new "taxable value" using the following formula:

*New Taxable Value* = "taxable value" + \$0 [if the "assessed value" upon the transfer is less than the "taxable value" plus \$1 million]; or "taxable value" + [the "assessed value" upon the transfer minus the "taxable value" and minus \$1 million (if the "assessed value" upon the transfer is equal to or more than "taxable value" plus \$1 million)].

Even for seasoned attorneys, the formula requires unpacking. In this context, "taxable value" means the present year adjusted base-year value. In other words, the "taxable

value” is simply the property tax value that is stated on the owner’s most recent property tax bill. In the example used above, the taxable value is \$500,000.

Additionally, in this context, “assessed value” means “full cash value” — that is, “the appraised value of real property when purchased, newly constructed, or a change of ownership has occurred.” This is frequently measured by fair market value and/or purchase price. Cal. Constitution XIII A, 2(a). In other words, “assessed value,” as used in Prop. 19, is fair market value. Again, using the example from above, the assessed value would be \$2 million, which is also the fair market value.

The new taxable value, based on this example, would be \$1 million (i.e., [\$500,000 taxable value] + [\$2,000,000 assessed value, minus \$500,000 taxable value, and minus \$1 million]).

## 5. Million-Dollar Questions

As noted above, Prop. 19 would require assessors to determine the fair market value for each property transferred under the principal residence exclusion, a process that will likely be time consuming and may produce flawed or imperfect results. As a protective measure, if there is any question that a parent-child transfer has the potential to result in increased property taxes, the transferee child would be wise to obtain a qualified appraisal and be prepared to submit the appraisal to the assessor with the parent-child exclusion application.

Additionally, beginning Feb. 16, 2023, and every year thereafter, Prop. 19 would require the \$1 million “cap” on the principal residence exclusion be adjusted for *inflation* to reflect the percentage change in the House Price Index for California for the prior calendar year. Though it’s unclear whether the \$1 million cap is subject to *deflation* as well, consider that the HPI can be extremely volatile (it deflated by more than 40% between 2006 and 2012, but has since recovered), whereas Prop. 13’s annual increases are based on changes to

the Consumer Price Index for California as the inflationary standard.

## 6. Elimination of the “Other Property Exclusion”

Under current law, in addition to the principal residence exclusion, each parent can also transfer to their children up to \$1 million of the adjusted base-year value of any non-principal residence property (e.g., commercial property, second home, rental property, etc.) without triggering a reassessment (the “other property exclusion”). If passed, Prop. 19 would eliminate this other property exclusion *entirely*. Thus, other things being equal, if your clients were thinking about using the other property exclusion for upcoming transfers to their children, the time to complete those transfers is now.

## 7. The Dell Maneuver, Dude — Taking Advantage of Legal Entities

Prop. 19 does not amend any change of ownership rules for properties owned by legal entities, which generally provide that legal entity interests can be transferred from current owners to new owners without triggering a reassessment (the rules make no distinction among parents, children, and other third parties), subject only to the change of control rule and cumulative co-ownership rules. This legal entity rule is sometimes referred to as the “Dell Maneuver,” whereby Michael Dell purchased the Fairmont Miramar Hotel in Santa Monica without triggering a reassessment. Setting aside the cumulative co-ownership rule, the change of control rule is relatively easy to bypass and thus, when structured correctly parents may transfer 100% of their legal entity interests (e.g., common stock, and LLC membership or partnership interests) to their children without triggering reassessment, much like the principal residence and other property exclusions discussed above.

If Prop. 19 becomes law, individual owners would therefore have an incentive to transfer their property to a legal entity to avoid future re-

assessment. Additionally, in light of Prop. 19, owners should consider whether it is preferable to transfer *recently* acquired property into an LLC right now, without claiming any exclusion and therefore resulting in a reassessment, to protect against future reassessment. The incremental increase in property value as a result of such reassessment should be modest (depending on how recent the property was acquired), and the benefit of relaxed legal entity change of ownership rules can be significant. It should be noted that there are regular attempts to close off the Dell Maneuver legislatively, but none have succeeded to date.

## 8. Increased Portability for Persons Over 55 and Wildfire/Natural Disaster Victims

Prop. 19’s other major changes would expand base-year value transfers from an original to a replacement dwelling for persons over 55 and victims of wildfire and natural disaster (i.e., “portability”). Under current law, portability is somewhat limited in that eligible claimants can only make one transfer per lifetime, only in the same county or in the 10 counties that permit intercounty transfers, and only where the purchase price of the replacement property is equal to or less than the purchase price of the original property.

Prop. 19 would substantially remove each of these barriers in that eligible claimants would be able to make three transfers per lifetime, in any county, and even where the purchase price of the replacement property is greater than the purchase price of the original property. In the latter case, the new taxable value would be equal to that of the replacement property, plus the difference in value between the sales price of the original property and the sales price of the replacement property.

## 9. Time for a Change

If passed, Prop. 19 would take effect on Feb. 16, 2021 (as to the parent-child exclusion changes), and April 1, 2021 (as to the

revised portability changes). You should expect a flurry of client activity between Election Day and those respective deadlines (more so for the former changes since the latter are mostly beneficial). While the natural response may be to utilize the parent-child exclusions before they are amended and eliminated, attorneys should advise whether the loss of other potential tax savings outweigh the benefit of a transfer under current law. For example, if parents transfer highly appreciated property to their children now, rather than upon death, then the children would not benefit from step-up in basis rules, which could be more valuable if the property will be sold.

## Conclusion

Next month voters will decide on not one, but two (the other being Prop. 15), propositions that could have far-reaching impacts on Prop. 13. If Prop. 19 is passed, parents with real estate will want to consider whether to take action ahead of the effective dates in early 2021, and attorneys should ensure familiarity with these revisions so that their clients are properly advised, and can make appropriate decisions on implicated transactions. Since the implementing provisions for Prop. 19 have not yet been prepared, attorneys should anticipate uncertainty in the near term, while new forms, reporting mechanisms, and overall implementation issues are resolved. ■

**Yin T. Ho** is a senior associate at *Withersworldwide*.

