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PROP 19 - MAKE THE KIDS PAY FOR IT

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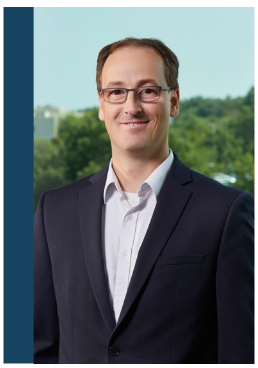

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An election in California just wouldn't be the same without the perennial batch of propositions. With the potential to affect everything from your Uber driver[1], to medical research and beyond, 2020's ballot propositions dramatically changed how the state operates. Of particular note is Proposition 19, which passed with 51.1% of the vote. The changes outlined in Proposition 19 will take effect in two separate phases early in 2021 and offer both opportunities and drawbacks. To begin, we'll look at the current law, the specifics of the new proposition and the timeline for implementation. From there, we'll review how the new proposition may affect investors and offer some considerations for your strategy going forward.

How It Worked Before Prop 19

Let's start with the basics. The prior law had two main features. First, it provided tax benefits for homeowners to downsize their home in retirement and second, it allowed certain heirs[2] to inherit real property with some meaningful property tax benefits as well. Looking at the downsizing benefits, the old law allowed homeowners over the age of 55 to downsize their principal home and buy another of the same or very similar value while maintaining their prior assessed value. Generally, the base value is the value of the home when it was bought, as adjusted up by 2% each year thereafter. The law allowed this to happen once (unless you were subsequently disabled) and the transactions had to be done within the same county or between a small group of California counties who had agreed to allow it.

As to the inheritance piece, the old law also allowed for your child or grandchild to inherit property and retain the same base year, no matter how they used the property. This was allowed with no restriction on your principal residence and included up to $1 million per parent of factored base year value on any other real property (i.e. rentals, etc).

The Good – Downsizing is Easier

Under Proposition 19 things have changed quite a bit. For those looking to downsize and stay here in California, things got quite a bit easier with the new law. However, for those inheriting property, things got a bit worse.[3] Let's tackle each piece individually.

When fully implemented, the new law allows homeowners over the age of 55 to sell their home and move anywhere in California. The new home may be of any value and will still retain the assessed value from the prior home assuming the property was purchased within two years of the sale of the prior home. Further, if the new home is worth more than the old home the difference will get added on to the base year value. This portion of the law will go into effect on April 1, 2021. Let's look at an example.

Assume John and Jane are moving from Orange County to Santa Clara County to be closer to their children. They are both over age 55 and are selling their home in Orange County that they bought many years ago. Let's assume their assessed value has grown to $250,000 over the years and the sales price will be $2 million. Just like under the old law they can move to Santa Clara County and buy a home worth $2 million or less and have no change in their property taxes. But what if the home they want is priced at $2.5 million? In this case, the excess amount of $500,000 would be added to their prior base value, resulting in a property tax assessment on $750,000. What if John and Jane decide to move again? The new law allows them to transfer their base value up to 3 times—building in a lot of flexibility for them to find the right home.

The Bad – The Kids are Paying for All of This

The second major portion of Proposition 19 makes significant changes to how children and grandchildren inherit real property. Recall that under the prior law parents could transfer their primary home, along with as much as $2 million of factored base value real estate, to their children or grandchildren without triggering a property tax reassessment. Further, the children could use the properties as they saw fit. The new law restricts both the value of the benefit and the use of the property.

Let's consider the impact of this new law on our friends John and Jane. This time, instead of moving out of Orange County, they decided to stay put.[4] When John and Jane pass, what happens if the kids keep the home and live in it? What about if they rent it out or even sell the home and take the cash?

$1M Leeway for Kids Inheriting a Primary Residence

Effective February 16, 2021 transfers to children of a primary residence are only eligible for the benefit if the child uses the home as their primary residence and the difference between the factored base value and the market price is less than $1 million.

Assuming John and Jane live in the property as their primary residence and then pass

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it down to their son who, in turn, uses the home as his primary residence two possible scenarios present themselves. Namely, taxes could stay the same or the property could be, partially, reassessed. The main driver of the change is the market value of the home at the time of John and Jane's passing. This is because the new law allows for $1 million of leeway when a child inherits a primary residence. Let's look at each scenario in more detail.[5]

Scenario 1: No Property Tax Increase

After a long and great life in Orange County, John and Jane die, and the assessed value of their primary residence is now $1.5 million. At the time of their passing, the home's market value is determined to be $1.8 million. Their son inherits the home and moves in, using it as his primary residence. To determine what, if any, change is applicable add the assessed value plus $1 million. (Ex: $1,500,000 + $1,000,000 = $2,500,000). Is the market value greater than the result? No, $1.8 million is less than $2.5 million. Since the market value is less than the sum of the assessed value plus $1 million, the child keeps John and Jane's lower assessed value.

Scenario 2: Property Tax Increase

Just as before, John and Jane die, and the assessed value of their primary residence is $1.5 million. However, in this scenario let's assume the market value of the home is $3 million. Since the market value of $3 million is now greater than the assessed value plus $1 million the difference of $500,000 is added to the assessed value. As a result, the assessed value now becomes $2 million and the child's property tax bill increases by roughly $5,000 per year.[6]

As a result, under Proposition 19, the children will have an incentive to sell. Why? Remember that once both John and Jane pass, any capital gains built up in the home will be wiped out and the kids can sell without paying capital gains taxes.[7] This contrasts with what would happen if they held the property out as a rental.

The Ugly – All Rental Property is Fully Reassessed

If the children hold the property as a rental, instead of moving in, the new law would fully reassess the property. How would that look? If we assume the market value is $3 million the new tax would be on the order of $30,000 per year instead of the roughly $15,000 under the old law. Assuming the home is paid off and they could rent the home for $7,000 per month that makes the annual income return from the property just 1.8%

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before accounting for any maintenance or other costs.[8]

Unfortunately, there are no property tax exemptions or exclusions for rental property that is passed to children when John and Jane die. While the old rules did provide up to $2,000,000 worth of factored base value exclusion for a married couple's rental property, Proposition 19 provides nothing at all. Accordingly, all rental property in California will suffer a complete reassessment when children inherit it unless planning and changes are complete in advance of the February 16th deadline.

Considerations for Investors

Investors and homeowners should consider the impact of a potential increased property tax bill on their larger financial and estate plan. Gifts or sales of real estate today, in advance of the change, or the use of transfers to various irrevocable trusts may allow parents to pass their low current assessed value to their heirs. To understand whether this strategy makes sense, focus on three main areas. First, this sort of gifting only makes sense if the heirs plan on holding the property for an extended period post inheritance, so as to accrue substantial annual savings. Second, a sufficient differential between current property taxes and the new rates under Proposition 19 should exist to cover the increased cost and complexity this sort of planning brings. Finally, the age and expected life expectancy of the parent's should be weighed against other needs for flexibility and the risk their estate planning goals may change over time.

Additionally, under the old rules, transfers of rental property owned by an LLC to children did not qualify for the highly favorable parent-child transfer exclusion and were completely reassessed when parents died and gave the property to their children. For this reason, many investors did not title their rental properties in LLC's so that they could pass property tax benefits to their kids. Under the new Prop 19 however, all California property tax benefits are lost and all rental property suffers a full reassessment when the parents die whether it is owned by an LLC or not. Accordingly, owners of rental property should now reconsider whether an LLC is a good idea for both property tax and liability protection purposes.

There are, however, potential downsides to these decisions. Gifting assets outright or through trust without adequate planning may transfer unrealized gains down to the heirs that would otherwise be wiped out when they inherit. In addition, there may be other considerations regarding potential liability protections as well as increased income tax rates under various scenarios. Careful planning is essential, and simplicity

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for your heirs in the administration of the assets is key. Your Creative Planning Wealth Manager, in concert with our team of in-house attorney's and CPA's can assist you in updating your strategy.

[1]Or Lyft - we are openminded.
[2]Your favorite cousin's son was out of luck as this was for children and, in limited circumstances grandchildren.
[3]What Prop 19 giveth, it taketh away.
[4]Those kids need to learn to come see them after all!
[5]Examples from the San Francisco Assessor during the "Digital Family Wealth Forum: Understanding How CA Prop 19 May Impact Your Family", January 5, 2021.
[6]I am using 1% as the tax rate to keep things simple. Actual tax rates vary.
[7]Note, there may be estate tax consequences to consider but that is outside the scope of this article.
[8]This isn't great. The math looks like this: $84,000 of rental income, less $30,000 property tax equals $54,000. This is then divided into the market value of $3M to arrive at a cash flow of 1.8%. Actual cash flow would likely be lower due to operating expenses.

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