PROPOSITION 19 AND PROPERTY TAXES: HOW IT WORKS, WHAT IT MEANS

California Proposition 19, which became law in November of 2020, went into effect on February 15th. As of that date, significant changes to California property tax law, particularly concerning parent-child exclusions, go into effect. The change also affects transferring property to yourself. And fascinatingly, there's a connection with the film The Big Lebowski, which wasn't really about real estate valuation. Bowling, yes. Real estate – not so much. And yet.

The Parent-Child Exclusion

The new law was created to close what's become known as the "Lebowski Loophole," a derisive name coined after it was revealed that actor Jeff Bridges (who starred as The Dude in The Big Lebowski) and his sister were discovered to be renting out a luxurious Malibu property for over $16,000 per week -- and paying 1970s-level property taxes on it. The new law not only closes this loophole, but locks, bolts and nails it shut. The result is that many homeowners will see significant jumps in their property tax bills after February 15th.

Under the old law, when parents give or sell real property to their children (or grandchildren, under some circumstances), the recipient pays property taxes on the same assessed value that the parents did. Typically, this amount is much lower than the actual market value of the property, because annual assessed value increases are capped. The assessed value then lags behind the real value of the property in an exploding real estate market. The result: lower taxes.

This tax break applied to properties with an aggregate assessed value of $1 million per person (or $2 million if both parents' exclusions are used). Note that this is assessed value, not fair market value. Fair market value isn't relevant under the old law.

In addition, under the old law, parents could also transfer a primary residence to a child, and the child retains the parents' assessed value. In other words, under the old law, parents could transfer up to $2 million assessed value in real estate, plus the family home, and a child would see no increase in property taxes. The new law changes almost all of these tax breaks. To quote The Dude: "This is a very complicated case Maude. You know, a lotta ins, a lotta outs, lotta what-have-yous."

The new law, first of all, basically eliminates the parent-child exclusion. Parents can still transfer their primary residence to a child. That being said, however, the child has to move in and make the place *their* primary residence to receive the exclusion, and claim it within a year of the transfer.

Furthermore, the only remaining exclusion is a maximum benefit of $1 million in fair market value. In other words, using simple math, imagine a home transferred to a child. It's been assessed at $1 million but has a fair market value of $3 million. At transfer, it will be reassessed at $2 million. That's full fair market value, minus the $1 million benefit. Also, none of this applies if the property isn't used as a primary residence. In those cases, there's an immediate reassessment of the property at full market value. And an equivalent increase in the tax bill. If you'd like to avoid this, and complete a transfer before the deadline, you need to consult with counsel immediately.

The Self Exclusion

Proposition 19 will also have a material impact on older California homeowners who are downsizing once the nest is empty, so to speak. Under the old law, homeowners over 55 who sell their original home and purchase another one of equal or lesser value can retain the first home's assessed value. The new home can be existing or new construction, has to be in a California county that allows such transfers, and must be purchased within two years of the sale of the original home.

Proposition 19 helps these buyer/sellers out. Sort of. First of all, they now can also be victims of wildfires and natural disasters, not just 55 or over. Second, the original home's base value can be used to reduce the taxability of the new home if the new home is of greater value than the original home. The old law limited relief to situations in which the new home was of lesser value. Third, the new home can be anywhere in California, and finally, the benefit is good for up to three transfers. However, it applies to transfers that take place on or after April 21st, so the timeframe is different.

The taxable value of the replacement home is calculated by adding the difference between the market value of the first home and the market value of the second to the taxable value of the first home to arrive at the taxable value of the second. Got that? Let's run through an example: A homeowner has a house with a taxable value of $400,000 and a market value of $1 million. He sells it, and replaces it with a house with a $2 million market value. His taxable value wouldn't be the full $2 million, but $1.4 million. That's calculated as the taxable value of the first house ($400,000) plus the difference in market value between the first and second houses ($1 million). In other words, your tax base is your original house, plus the market value of your upgrade, so to speak.

The bottom line, then, is that if you're planning to transfer property to a child, the simple, obvious property tax benefit expired on February 15th. And if you were planning to change properties for yourself, you may want to wait until late April or consider another option. In either situation, there may still be workarounds, such as using a business entity as an ownership vehicle, setting up a trust, and so on, but those will require consultation with counsel, and may not be feasible.

And whether these changes affect you or not, as The Dude also said, "Life goes on, man."

Coleman & Horowitt, LLP's estate planning department helps clients in the transfer of wealth from one generation to the next. Proposition 19 may prompt you to consider a transfer of property as a result of the change in the law. If you have questions, please contact Michael Dowling, Eliot Nahigian, Sheryl Noel or Stacy Bowman at (559) 248-4820 or (800) 891-8362.

About the Firm:

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