

Three Ways to Save your Heirs Thousands in Property Taxes¹

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In California, one's property tax basis can increase only 2% per year unless a change in ownership is recognized. This bodes well for children of property owners: parents can pass on a house to their children without recognizing any change in ownership. The effects can be significant. For instance, say Bill Parent bought his California house in 1979 for \$300,000. Annual property taxes are fixed at 1% of the assessed value, which can increase only by 2% per year. Thus, property taxes, which were \$3,000 per year in 1979, would only be \$5,434 per year in 2009, assuming the maximum 2% increase in basis were imposed. Today, the house is worth \$1.2 million. If a change in ownership were recognized, the new owners would start with \$12,000 in annual property taxes! However, if Bill Parent sells the house to his child, or leaves the house to his child under a will or trust, no change in ownership would be recognized, and the child would save thousands annually by inheriting his parent's property tax basis. Well meaning parents often lose the exception from reassessment inadvertently. In this article, we explore three ways that the exception from reassessment can be lost, and what to do about it.

1st Mistake: The Buyout

Bill Parent decides to write his will, which gives his assets to his two children, Timmy and Tammy, equally. At his death (Bill Parent was a widower), neither Tammy's nor Timmy's 50% share of the house will be reassessed. However, Timmy wants to "buy out" Tammy from her share of the house. While Bill Parent wanted everything to be equal, what two siblings can share a house? Unfortunately, because no sibling to sibling exception from re-assessment exists, the 50% share passing to Timmy will be re-assessed at its current value. This would leave Timmy with a \$11,434 bill for property taxes rather than a \$5,434 bill.

There are a number of ways Bill Parent can prevent making this mistake. First, he can give the house to the child who needs it most. The problem with that approach is the final distribution of assets might not be equal. He also may not know who would need the house most at the time of his death. Second, he can create a revocable living trust, giving the trustee discretion to make non pro rata allocations of all property in the trust. This allows the trustee to give the house to one child and the remaining assets to another as long as the end values are equal. The problem with this approach is that there may not enough assets in the trust to equalize the distribution. Accordingly, the trustee may be given the discretion to mortgage the house. The house passes to Timmy, preserving the full exemption. The proceeds of the loan pass to Tammy, equalizing the transaction. At the end of the day, Timmy preserves the low property tax basis enjoyed by Bill Parent, and Tammy inherits assets of equal value.

2nd Mistake: To my close friend, for her life

¹ This article is intended to provide general information about estate planning strategies and should not be relied upon as a substitute for legal advice from a qualified attorney. Treasury regulations require a disclaimer that to the extent this article concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.

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Bill Parent's wife passed away years ago. His close friend Renée has been his trusted companion during the last years of his life, and Bill is Renée's main financial support. Renée is advanced in years, and Bill doesn't know who will pass away first. Bill wants to make sure that upon his death, Renée will be well provided for if she is still living. He writes his will, giving Renée the right to live in the house until her death, after which time the house will pass to Timmy and Tammy. Bill Parent doesn't know too much about Property Law, but he heard from Tammy, a law student, that a life estate is not equal to a "fee simple absolute." Therefore, Bill Parent figures that the house won't be reassessed since Renée will never actually "own" the house outright.

When Bill Parent passes away, Renée is still living. The house will be reassessed, because Renée will be deemed to have received a "present interest" in the property, and no exception exists for transfers to close friends. While Renée doesn't own the house in "fee simple absolute," she does have a right to immediate possession. Under California law, that suffices as a change in ownership and the new property tax basis will be \$1.2 million. When Renée passes away, the children will face the full property tax bill.

Unfortunately, it will be difficult to give Renée any rights regarding the house without losing the exception from reassessment. Bill can provide for Renée, however, by setting aside assets other than the house in his trust, and giving the trustee discretion to pay income to Renée for her life, with the principal passing to the children upon her death. This alternative achieves Bill's goal of financial support without sacrificing the parent-child exception from reassessment.

3rd Mistake: Transfers to Grandchildren

Tammy has graduated from law school, pursued a successful career, and now has a child of her own, Tasha. Bill Parent would like Tasha to have the house, since both of his children now have homes and Tasha needs it the most. However, Bill Parent realizes that he would lose the parent-child exception from reassessment. Accordingly, he writes his trust, providing that Tammy will have a right to purchase the house, after which she will be required to sell the house immediately to Tasha. Bill Parent pats himself on the back: this way, he figures, he will take advantage of two parent-child exceptions. He believes that both transfers will preserve the low property tax basis.

Unbeknownst to him, a rule called the "step transaction doctrine" will treat a set of transactions as a single transaction if the purpose was to avoid taxation. Because Bill Parent's trust explicitly requires Tammy to transfer the house to Tasha, the intent to avoid reassessment appears clear. Bill Parent should therefore not require that Tammy sell the house to Tasha. Unfortunately, there is no clear law as to how much time must pass before Tammy can then sell the house to Tasha while preserving her own parent-child exception. Bill Parent, and later his trustee, should consult with a lawyer to make sure that a sale does not unknowingly trigger the step transaction doctrine.

Conclusion

Proposition 13 has enabled property owners to transfer real estate to their children with a low property tax basis. However, several common mistakes thwart the parent-child exception. It's always a good idea to consult with a lawyer when preparing a will or trust, or handling a decedent's estate. A little bit of good advice can save your heirs thousands in property taxes.