

Fairmont Miramar Hotel in Santa Monica, California



# PROPERTY TAX PLANNING FOR THE REAL ESTATE INVESTOR AFTER PROPOSITION 19



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**John Goralka** is a California State Bar Certified Specialist in Taxation as well as Estate Planning, Trust and Probate. He is one of only one (1) hundred attorneys in California with both of these critical specializations. John successfully completed the Certified Public Accountants (CPA) exam and holds a Master of Laws in Taxation Law (LLM). John's firm receives numerous awards and recognition. Perhaps most notably for a small, boutique firm, the Goralka Law Firm is recognized by its peers as one of the best law firms in America by US News and World Report. John is AV Rated with Martindale, which is the highest possible rating for legal ability and ethics. The Goralka Law Firm was selected by the Los Angeles Daily Recorder as one of the Top Boutique Law Firms in 2016. More recently, John was recognized as one of the top Tax Lawyer's in the Country by Premier Tax Lawyers. John has also been recognized as one of the top attorney's in California for Business, Taxation, and Estate Planning.

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## PROPOSITION 19 - OVERVIEW

- In the November elections, California voters passed Proposition 19 by a 51.1% majority
- Prop. 19 (with variations) had been on prior years' ballots but did not receive enough votes
- Major selling point was that tax dollars would go towards wildfire response



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## PROPOSITION 19 - OVERVIEW

- Prop. 19 brings two major changes to the property tax rules
  - (1) Restricting parent-child transfer exclusions; and
  - (2) Expanding rules for homeowners age 55 and older, disabled homeowners, and natural disaster victims
- This presentation focuses on the restriction to the Parent-Child Exclusion for property and planning to mitigate the effect of this change



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## PROPOSITION 19 - TRIVIA

- Prop 19 was put forth by the California Association of Realtors (CAR) to increase sales. The virtual elimination of the parent-child exclusion and the extension of the Over 55 Base Year Transfer will likely increase sales volumes over time.
- Roughly 2/3 of California's revenues come from 35,000 wealth residents. California income was vulnerable to:
  - Changes in the stock market
  - Wealthy residents leaving eq: Elon Musk
- Proposition 19 brings more changes in ownership resulting in more frequent reassessments and generally higher property tax revenue.



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## PARENT-CHILD EXCLUSION - WHAT WE LOST

- Revenue & Taxation Code §63.1 provides that a change in ownership does not include the transfer between parents and children (in either direction) of:
  - 1. A Principal residence; and
  - 2. The first \$1 million of Trended Base Year Value of all other real property
- \*May be greater need for Trust planning – if no parent-child exclusion, reassessed as of the date of death. Delays with probate results in exposure to the higher property tax until the property is sold!



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"I MADE MY MONEY THE OLD-FASHIONED WAY. I WAS VERY NICE TO A WEALTHY RELATIVE RIGHT BEFORE HE DIED."  
- MALCOLM FORBES



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## PARENT-CHILD TRANSFERS

- Old Law Example 1:
  - Mother transfers 100% of Blackacre to child and Blackacre is the mother's principal residence
  - The assessed value is \$3,500,000
    - P/tax: \$35,000 annually
  - The fmv of Blackacre is \$8 million
    - P/tax: \$80,000 annually
  - No reassessment
  - Property tax rates 1.0% to 1.2%



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## PARENT-CHILD TRANSFERS

- Old Law Example 2:
  - Mother transfers 100% of Blackacre to child and Blackacre is not a principal residence
  - The assessed value is \$350,000
    - P/tax \$3,500 annually
  - The fmv of Blackacre is \$1,200,000
    - P/tax \$12,000 annually
  - No reassessment. \$350,000 of the mother's \$1 million exclusion is used.



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## PROP. 19 PARENT-CHILD TRANSFERS

- Effective 2/16/21, the parent-child exclusion remains in a limited fashion
  - The parent-child exclusion applies for the transfer of a parent's (or child's) principal residence to a child (or parent), who actually uses it as his or her principal residence (the child must file for the homeowner's exemption within one year of the transfer).
  - The exclusion is further limited to the house's base year value plus one million dollars, as adjusted annually by the State Board of Equalization.
  - The \$1 million for non-principal residence property is entirely eliminated.



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**“MONEY IS LIKE A SIXTH SENSE — YOU CAN’T MAKE USE OF THE OTHER FIVE WITHOUT IT.”**  
- WILLIAM SOMERSET MAUGHAM



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**PROPOSITION 19 IS A REMINDER THAT OTHER PLANNING REMAINS AVAILABLE & UNAFFECTED**



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### WHY ARE WE HERE TODAY?

- Michael Dell and his family/investors **acquired** the Fairmont Miramar Hotel in Santa Monica for \$200,000,000 **without** a reassessment in property tax.
  - Annual savings: \$1,000,000
- This transfer was challenged at appeal – not only did Michael Dell prevail, but he recovered over \$252,000 in legal fees from the Tax Board.



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### WHY ARE WE HERE TODAY?

- Michael Dell effectively acquired 48%
- Michael's Wife acquired 49% in her separate property Trust
- Two (2) other insiders joined the transaction
- \*See Ocean Avenue LLC v. County of Los Angeles



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### WHY ARE WE HERE TODAY?

- In 2002 E & J Gallo purchased Louis M. Martini which owned 1,000 acres of prime Napa and Sonoma Vineyards
  - **NONE** of that property was reassessed
- Land continues to have property tax based on it's 1975 value of a few thousand dollars an acre
  - **Worth perhaps \$150,000 per acre now**
- Careful planning is required when the property is first acquired
- **Best result** – do not acquire the property individually and transfer to LLC; **acquire the property directly in the LLC** (KEY – AVOID THE "TAINT")



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## PROPOSITION 13: CALIFORNIA CONSTITUTION ARTICLE XIII A

- Limited Annual Increases in Assessed Value of Real Property to an Inflation Factor, Not to Exceed 2% Per Year ("Trended Base Year Value")
- Prohibited Reassessment of a New Base Year Value except Upon:
  - A) Change in Ownership or
  - B) Completion of New Construction



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## DEFINITION OF CHANGE IN OWNERSHIP: REVENUE & TAXATION CODE § 60

- Three Elements:
  - Transfer of a present real property interest;
  - Including the beneficial use thereof; and
  - The value of the interest is substantially equal to the value of the fee.



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"THE SAFEST WAY TO DOUBLE YOUR MONEY IS TO FOLD IT OVER AND PUT IT IN YOUR POCKET."

- KIN HUBBARD



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## HOW TO NOT COMMIT MALPRACTICE NOTE: COMMON SENSE DOES NOT APPLY



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## AVOID NON-PROPORTIONAL TRANSFERS IF POSSIBLE

- Husband and Wife own Blackacre as community property
- For asset protection purposes, Husband and Wife transfer Blackacre to family limited partnership owned 99% by Husband and Wife as community property and 1% by a corporation owned by Husband, Wife and Daughter
- Reassessable change in ownership



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## SEEK PROPORTIONAL TRANSFERS IF POSSIBLE

- Revenue & Taxation Code §62(a)(2) excludes from a change in ownership "Any transfer between an individual or individuals and a legal entity or between legal entities... that results solely in a change in the method of holding title to real property and in which proportional ownership interests of the transferors and transferees... remain the same after the transfer."



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## SPOUSAL TRANSFER REDONE

- Husband transmutes Blackacre to community property
- Husband and Wife transfer Blackacre into LLC owned 50% by Husband and 50% by Wife
- **No change in ownership**

(Proportional Transfer)



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**“A BANK IS A PLACE THAT WILL LEND YOU MONEY  
IF YOU CAN PROVE THAT YOU DON’T NEED IT.”  
- BOB HOPE**



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## ENTITY TRANSFERS

- Revenue and Taxation Code §64(c) provides that a **change in ownership occurs** when a person obtains control of **more than 50%** of the voting stock of a corporation or obtains **more than 50% of the ownership** interest in any partnership, LLC or other legal entity.



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## ENTITY TRANSFERS

- LLC is owned 90% by Mother and 10% by Son
- LLC purchases Blackacre
- Mother dies and leaves 50% of her interest to Son and 50% of her interest to Daughter
- 100% reassessment
- Son acquired more than 50% interest (45%+10%)



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## ENTITY TRANSFERS

- LLC is owned 100% by Mother
- LLC purchases Blackacre
- Mother dies and leaves 100% of her interest to only child
- 100% reassessment
- Child acquires more than 50%



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## ENTITY TRANSFERS REDONE

- LLC is owned 90% by Mother and 10% by Son
- LLC purchases Blackacre
- Mother dies and leaves:
  - 1. 50% of her interest to Daughter; 44% to Son and 6% to Daughter-in-law (or Grandchild); **or**
  - 2. Mother could structure her estate so that Daughter and Son each end up with 50% of LLC
- No change in ownership
- No one acquired more than a 50% interest



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## ENTITY TRANSFERS REDONE

- Mother owns 100% of LLC and has only 1 child
- LLC purchases Blackacre
- Mother dies and leaves:
  - 1. 50% to Son and 50% to Daughter-in-law
  - OR
  - 2. 50% to Son and 50% to Grandchildren
- **No change in ownership**
- **No one acquired more than a 50% interest**



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“EVERY DAY I GET UP AND LOOK THROUGH THE FORBES LIST OF THE RICHEST PEOPLE IN AMERICA. IF I’M NOT THERE, I GO TO WORK.”  
- ROBERT ORBEN



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## THE “TAINT”

▪ Section 64(d) provides that **if property was transferred** to a legal entity then in addition to the “one person obtaining control (64(c) rule” **there is also a change of ownership when more than 50% of the original co-owner’s interests are cumulatively transferred.**



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## THE "TAINT"

- Mother owns 100% of Blackacre
- Mother places Blackacre in LLC she owns 100% of – No change in ownership 62(a)(2)
- Mother dies and leaves LLC 50% to Son and 50% to Daughter
- **Change in Ownership** – More than 50% of the original (co-owner's) owner's interests are **cumulatively transferred**



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## THE "TAINT"

- Husband and Wife transfer Blackacre to LLC
- LLC owned by Husband (50%) and Wife (50%) (assume "taint" applies)
- Husband dies and transfers his 50% to Son (25%) and Daughter (25%)
- Wife transfers 5% to Son
- **Change in ownership (25%+25%+5%=55%)**
- **Transfer of more than 50% of original co-owners**



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## THE "TAINT"

- LLC owned by Husband (50%) and Wife (50%) (assume "taint" applies)
- Husband dies and transfers his 50% to Son (25%) and Daughter (25%)
- Son transfers 5% to Friend
- **No change in ownership – Interest transfers only count once**
- **No more than 50% of original co-owner's cumulative interest were transferred**



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## THE "TAINT"

- LLC owned by Husband (25%), Wife (25%), Daughter (25%), and Son (25%)
- Husband dies and transfers 25% to wife
- Son transfers 25% to Friend
- Daughter transfers 25% to Friend
- **No change in ownership**
- **Inter-spousal transfers don't count towards the 50%**



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## THE "TAINT"

- LLC owned by Husband (50%), Son 1 (20%), Son 2 (20%), and Daughter (10%)
- Husband dies and transfers 5% to Son 1, 5% to Son 2, and 40% to Daughter
- **No change in ownership - However any party can trigger a change in ownership by transferring .1% - reliance on other parties**
- No one person holds more than 50% (voting or ownership)
- Not more than 50% of the original co-owner's interest was transferred



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**"MONEY IS LIKE MANURE. YOU HAVE TO SPREAD IT AROUND OR IT SMELLS."**

**- J. PAUL GETTY**



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## REPORTING REQUIREMENTS



- Revenue & Taxation Code § 480.1 -Whenever a legal entity experiences a change of ownership "as defined in subdivision (c) of Section 64, a signed change in ownership statement...shall be filed...within 90 days from the date of the change of control..."
- Revenue & Taxation Code §480.2 imposes the same requirement for a change of ownership that results pursuant to Section 64(d).
- Trap – with death need to report within 90 days and may not even know yet



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## PROP 19: LLC STRATEGY AFTER 2/16/2021

- Parents transfer property directly to LLC, not children; no reassessment
- Once in LLC, parents transfer 50% to children; no reassessment
- After gift reported and audit risk has passed, terminate LLC and distribute property 50% to parents 50% to children; no reassessment
- Form new LLC with parents remaining 50%
- Repeat as necessary
- Children create their own LLCs to pass their interests to the grandchildren



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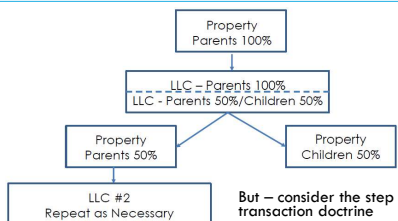
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## PROP 19: LLC STRATEGY AFTER 2/16/2021



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## PROP 19: LLC STRATEGY AFTER 2/16/2021

- Gifts must be reported on Form 709
  - Current appraisals required
  - Timely filed 709 rebuts the claim by a County Assessor that the transfer was a property tax avoidance scheme and not a "real" transfer
- Income going forward must be reported correctly
  - Form 1065 (Partnership Return)
  - Schedule K-1
  - Income picked up on appropriate Form 1040
- Remember: Section 1031 exchanges can be used to solve the capital gains problem arising from loss of the step up in basis on the parents' death



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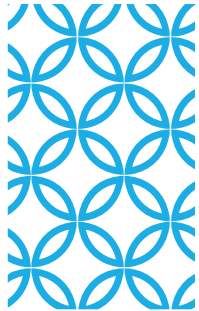
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# THANK YOU!

## Questions?

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