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IN THIS ISSUE

ACT NOW IF YOU WANT TO SAVE PROPERTY TAXES: SAYING GOODBYE TO THE PARENT-CHILD EXCLUSION AS WE KNOW IT

By DeEtte L. Loeffler, J.D., LL.M., Taxation

A key benefit for California real property owners was substantially limited by the passage of Proposition 19 in November. This change is widely expected to cost California property owners millions of dollars in new property taxes upon the transfer of real property. Property owners only have until **February 15, 2021** to make use of the "old" parent-child exclusion before the new law goes into effect.

The Old Law: Effective until February 15, 2021

Principal Residence. Under the old rules, an individual could transfer (by gift, sale or bequest) a principal residence of any value to his or her children, and the property taxes on that residence would not increase. The exclusion applied to the transfer of either the primary residence or a second home. The parent could make such transfers any number of times so long as the transfer was made to the children. In addition, if a child predeceased the parent, the property could instead be transferred to grandchildren so long as both of the grandchild's parents were deceased and the grandchildren had not already received a personal residence from their parents. Late elections were permitted, but generally applied only prospectively (meaning no refunds would occur) if the application was filed more than three (3) years after the transfer occurred, or after a transfer to a third party.[1]

Other Property. In addition, a parent could transfer "other" California real property with a combined assessed value of up to $1,000,000 to children (or grandchildren, as noted above), during lifetime or at death, so long as the property was held individually or in a revocable trust (i.e., transfers of interests in an entity holding the property did not qualify). For example, a parent owning a commercial property valued at $1.5 million and assessed at $400,000 could transfer the commercial property, or several such properties, to the children without a reassessment so long as the assessed value of all of the properties combined did not exceed $1,000,000. If it did exceed $1,000,000, then a partial reassessment would occur for the portion above $1,000,000.

[1] California Revenue and Tax Code Section 63.1.

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<u>New Law Under Proposition 19: Effective February 16, 2021</u>

Proposition 19, *The Home Protection for Seniors, Severely Disabled, Families, and Victims of Wildfire or Natural Disasters Act*, amends the California Constitution, Article XIII A, Sections 2.1, 2.2 and 2.3. This amendment virtually eliminates the parent-child exclusion for most people.

Other Property. First, it eliminates the ability of individuals to transfer "other property" without a property tax reassessment. Under the example above, the commercial property would be reassessed from $400,000 to $1.5 million, increasing the annual taxes on the property from approximately $4,000 to $15,000. While this may not be significant to the new owner when the property is subject to a triple net lease since the tenant has to pay the increased taxes, it may make re-leasing the property more difficult, and could push financially struggling tenants out of the property.

Principal Residence. Second, Proposition 19 severely restricts the use of the principal residence (now called the "family home") exclusion. The exclusion can now only be used as follows:

a. If the property is the taxpayer's principal residence. (This change eliminates the ability to gift second homes).
b. The transferee must make the property his or her own primary residence, and file a homeowner's exemption (or disabled veteran's exemption) within one year of the transfer; and
c. The exclusion is limited to no more than $1,000,000 of difference between the assessed tax value of the property and its fair market value on the date of the transfer (any excess value is reassessed).

The $1,000,000 exclusion is indexed for inflation starting February 16, 2023, and every other year thereafter, to the House Price Index for California for the prior year as determined by the Federal Housing Finance Agency. The adjusted amount is to be calculated and published by the State Board of Equalization.

Several things remain unclear. First, if a taxpayer has already used the parent-child exclusion on the transfer of a primary residence before February 16, 2021, can he or she also use the $1,000,000 exclusion for the transfer of another residence after Proposition 19 goes into effect? The bill provides no guidance on this issue. Second, can the exclusion be used to transfer more than one primary residence (at different times) so long as the total exclusion claimed does not exceed $1,000,000? Third, if the transferee who otherwise qualifies fails to file a homeowner's exemption within one year of the transfer, will the parent-child exclusion still apply prospectively, or will it be denied altogether? Fourth, if several children inherit the family home but only one child moves into it, will all, a portion, or none of the property qualify for the exclusion?

Proposition 19 also adds a new exclusion for "family farms." These will also qualify for the principal residence exclusion, but many details for how this exclusion will apply are unclear.[2] A family farm is defined as "any real property which is under cultivation or which is being used for pasture or grazing, or which is used to produce any agricultural commodity, as that term is defined in Section 51201 of the Government Code as that section read on January 1, 2020."[3] "Agricultural commodity" means "any and all plant and animal products produced in this state for commercial purposes, including, but not limited to, plant products used for producing biofuels, and industrial hemp cultivated in accordance with Division 24

[2] California Constitution, Article XIII A, Section 2.1(c)(3).
[3] California Constitution, Article XIII A, Section 2.1(e)(2).

(commencing with Section 81000) of the Food and Agricultural Code."[4]

These definitions leave open the following questions: While it appears the transferor does not have to live on the land, does the transferor have to farm the land personally, or can another relative do the farming? Can the land be leased out to a third party for farming? Does the recipient have to farm it personally, or can it be leased out? Hopefully more guidance will be forthcoming on these issues as new Property Tax Rules are adopted by the state.

Who Is Affected by Proposition 19?

Not only the "wealthy" will be affected by this change. Anyone holding real property they want to transfer to their children (or grandchildren in certain cases) while retaining the current property tax basis is affected. In many cases, the only way the children will be able to afford to own a house in Coronado, La Jolla, or Rancho Santa Fe will be if the property taxes remain low. We have already spoken with several people in this situation who do not have "taxable estates" but see their most valuable possession as a home with a low property tax basis. Such people have a difficult decision to make between two taxes: either (1) make the gift before February 16, 2021 to keep the low *property* tax basis, but thereby to also transfer their current (presumably low) *income* tax basis in the property, or (2) wait to transfer the property at death so the property will receive a new (presumably stepped up to fair market value) *income* tax basis, but also a new, higher annual *property* tax requirement.[5]

Surviving spouses of recently deceased persons may be in the best position to make such gifts now as they will have already received a new income tax basis so will not face that particular dilemma. Of course, before making any gift it is essential that the donor not put his or her personal financial security at risk just to provide a better property tax situation for the next generation. Giving away your personal residence could result in you having nowhere to live.

Another common estate planning technique used by the non-wealthy is also now at risk – the life estate. For example, it is not uncommon for an individual in a second marriage to leave the new spouse a life estate in the property, with the property to pass to the individual's children following the new spouse's death. However, any property held subject to a life estate is not reassessed as a "change in ownership" until the life estate ends. The Assessor's Handbook provides that "[t]he date of a change of ownership of a life estate is the date the right of present possession or enjoyment of the property vests in the remainderman."[6] Since "present possession and enjoyment" of the property does not pass to the children until the life estate ends, the transfer might not be complete for property tax purposes until after February 15, 2021 when the Proposition 19 changes go into effect. Moreover, this method of transfer may result in a property tax reassessment following the new spouse's death if the value of the residence continues to grow.

In addition, certain types of irrevocable trusts which hold real property will also be affected. For example, property held in a Qualified Personal Residence Trust ("QPRT") will be affected because the donor retains a right to live in the property for a set period of time. Such trusts are established not only by the wealthy, but in some cases also by professionals in high risk professions (such as engineers, doctors or

[4] Government Code Section 51201.

[5] It is worth noting that President-elect Biden has included eliminating the basis step-up rules of IRC Section 1014 in his tax plan, so a future step-up in income tax basis at death is less likely than before the election.

[6] Assessor's Handbook dated September 2010, as reprinted 2015, Section 401, page 8, citing Property Tax Rule 462.260(d)(2)(B). Although subsection (A) refers to the change in ownership occurring when the trust is established, subsection (B) overrides this if a life estate in a person that is excepted from the change in ownership rules precedes the transfer to the party that does not so quality.

lawyers) seeking creditor protection. Existing trusts holding very low property tax basis homes should be reviewed to determine if they can (or should) be terminated before February 16, 2021 and a new transfer completed (which may be possible given the current very high exclusion from the federal estate tax).

Trusts used for other types of planning may also be affected. According to Attorney Yvonne Amrine of Amrine Law in San Diego, individuals engaging in certain types of Medi-Cal planning may also be adversely affected. Such planning can include making lifetime transfers to an intentionally defective grantor trust ("IDGT"), which is an irrevocable trust that is complete for federal gift tax purposes, but which is "incomplete" for income tax purposes. In cases where the trust gives the Settlor a right to continue to use the real property for a set term, this might result in the parent-child exclusion not applying to the transfer until the Settlor dies or the term expires.[7]

Moreover, it is unclear whether real property gifted to an irrevocable trust where the trustee is not required to make distributions to the beneficiaries would also fail to qualify as a completed transfer for property tax purposes. It may be necessary to review such trusts and amend them before February 16, 2021, if possible, to require the income from the real property to be distributed so as to ensure the transfer is considered "complete" for property tax purposes (assuming such a change can be made without a court order and will not cause any other tax issues).

Certain actions taken before February 16, 2021 may also allow owners of "other property" to defer a reassessment until a later date. For example, if a parent were to transfer a controlling interest in rental real property to a child using the parent-child exclusion prior to February 16, 2021, the current exclusion could shield that transfer from a reassessment now. If the parent and child were then to form an entity to hold the property, under the Original Co-owners Rule no reassessment would occur until more than fifty-percent (50%) of the original membership interests are transferred (either by the child or the parent).[8] Since in most cases the parent will die first, a reassessment would be delayed since the parent held less than fifty percent (50%). However, once this threshold is crossed, the entire real property will be reassessed, not just the portion owned by the transferor.

Finally, because of the way the state treats life estates, a technique currently being promoted as a solution to Proposition 19 does not appear to work. The technique includes signing a deed now to transfer title to the real property to the children, but retaining a life estate in the transferor. Revenue and Tax Code Section 62(e) specifically excepts an estate for years or life estate retained by the transferor from the Change in Ownership rules. The retained life estate, or even a retained estate of years, should not qualify as a change in ownership and therefore the property will be reassessed <u>after</u> the February 15, 2021 deadline.

<u>Other Changes Made By Proposition 19</u>

Of course, Proposition 19 was promoted as a way to help seniors, the disabled and the victims of fires and natural disasters, which it also does. Under the new law, starting on April 1, 2021 homeowners over age 55, or who are "severely disabled", or who lose homes to certain wildfires or natural disasters will be able to transfer the property tax base value from their homes (or destroyed homes) to a replacement home anywhere in the state. If the purchase price of the replacement home is less than or equal to the sales price of the original home, the tax basis in the old home simply becomes the tax basis in the replacement home. If the purchase price of the replacement home is more than the sales price of the original home, the difference in price is added to the tax basis in the old home.[9] Prior to this change, homeowners over age 55 who lived in certain

[7] *See* Revenue and Tax Code Section 62(d)(1).

[8] Revenue and Tax Code Section 64(d).

[9] California Constitution, Article XIII A, Section 2.1(b)(2).

counties could already transfer their property tax basis to a replacement home in any of the nine (9) counties that allowed reciprocal transfers, including San Diego, Orange, Riverside, San Bernardino, Los Angeles, Ventura, Alameda, San Mateo, Santa Clara, and Tuolumne. However, such transfers could only be made to a property of equal or lesser value than the one replaced. (See prior Propositions 60 and 90).

Proposition 19 allocates fifteen percent (15%) of the net revenue generated to reimburse counties that experience a net loss of property tax revenue as a result of these changes. It also allocates seventy-five percent (75%) of the net revenue from the new taxes to pay staffing costs for wildfire suppression programs in underfunded special districts.

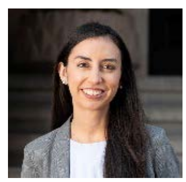
Using the Parent-Child Exclusion Going Forward

Since the parent-child exclusion is no longer unlimited for a personal residence, parents who own a principal residence they wish to leave to a child after February 15, 2021 should re-examine their estate plans to ensure they permit the full use of the exclusion. Each parent has the ability to transfer up to $1,000,000 of excess value in a property, but that transfer must be made either directly by the parent, or through the medium of a qualifying trust. If the parents' estate plan does not (i) transfer the principal residence to the children at the death of each parent, or (ii) transfer that interest in the principal residence to an irrevocable trust for the benefit of the surviving spouse, then the transfer will not qualify to use the exclusion of the first spouse to die.

For example, if the parents hold title to the family home as community property with right of survivorship, when the first parent dies the other parent becomes the sole owner of the property. In this situation, the exclusion of the first parent is wasted as the transfer did not go to the children. Likewise, if the family home is held in a trust and following the death of the first spouse, the survivor received sole ownership of the family home in the survivor's trust, then the exclusion of the deceased spouse is lost. If, however, the family home were transferred to a disclaimer, bypass or marital trust for the surviving spouse's lifetime, the transfer should qualify despite the surviving spouse's life estate in these trusts, with the change of ownership occurring upon the death of the surviving spouse.[10]

Conclusion

If you wish to use your parent-child exclusion prior to the changes going into effect on February 16, 2021, we recommend you speak with your attorney immediately to ensure you are a good candidate for making such gifts.



DISINHERITED BENEFICIARIES GET THEIR DAY IN COURT: BAREFOOT V. JENNINGS

By Erika P. Sanchez, J.D.

Earlier this year, the California Supreme Court allowed disinherited trust beneficiaries with well-pleaded petitions to get their day in court. The case, *Barefoot v. Jennings*, 8 Cal. 5th 822 (2020), addressed a pivotal issue in trust proceedings: whether a trust beneficiary has standing to contest the validity of amendments to a revocable trust that disinherited her.

Barefoot involved a plaintiff who was previously named as the successor trustee and as one of the beneficiaries of the trust. Her mother, the Trustor, executed 24 amendments to the trust throughout her life. The last eight amendments and restatements of the trust were made in the last three years of the Trustor's life and expressly disinherited the plaintiff and removed her as a successor trustee. After the Trustor's death, the daughter petitioned in probate court

[10] See Assessor's Handbook dated September 2010, as reprinted 2015, Section 401, page 26, citing Property Tax Rule 462.160(a); (b).

alleging incompetence, undue influence, and fraud. The trial court dismissed the petition and the court of appeal affirmed.

The appellate court's decision centered on its interpretation of Probate Code Section 17200(a), which provides that "[e]xcept as provided in Section 15800, a trustee or beneficiary of a trust may petition the court under this chapter concerning the internal affairs of the trust or to determine the existence of the trust."[11] The appellate court's narrow interpretation of Section 17200 excluded even wrongly disinherited beneficiaries.[12]

The California Supreme Court disagreed with the lower court's interpretation of Section 17200. It began by emphasizing that a court "may not simply assume the allegations supporting standing lack merit and dismiss the complaint."[13] Standing is determined by "treating the properly pled allegations as true."[14] If the court finds standing after treating the allegations as true, the litigation may proceed.

Further, the Supreme Court looked to the definition of a "beneficiary" under Probate Code Section 24(c) and applied it to Probate Code Section 17200(a). Pursuant to Probate Code Section 24(c), a trust beneficiary is "a person who has any present or future interest, vested or contingent." Accordingly, assuming the *Barefoot* "plaintiff's allegations [were] true, she has a present or future interest, making her a beneficiary permitted to petition the probate court under section 17200."[15] Thus, plaintiffs with well-pleaded allegations which show "they have an interest in a trust—because the amendments purporting to disinherit them are invalid . . . [may] petition the probate court."[16]

The court's decision is rooted in common sense. It would be illogical to bar a beneficiary whose disinheritance was a product of incompetence, undue influence, or fraud since they would have no opportunity to challenge that fraud. The Court's holding provides a necessary mechanism for disinherited beneficiaries to challenge apparently invalid trust amendments and ensure the Trustor's true intent is honored.

FEDERAL TAX NEWS
By Katie Lepore, CPA, J.D., LL.M., Taxation

Deductions for PPP Loan Expenses. Previously the IRS issued Notice 2020-27, which stated that no tax deductions would be allowed for expenses paid with PPP loan funds which are later forgiven. The IRS then released a safe harbor in Revenue Procedure 2020-51 to provide procedures for taxpayers to deduct expenses if the funds are not forgiven in a later year as expected. Some tax professionals still believe the disallowance of deductions is contrary to the intent of the *CARES Act*. Taxpayers who received PPP funds may wish to extend 2020 tax returns until there is further guidance.

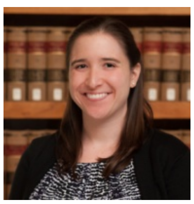
SALT Limits Don't Apply to Entities. On November 9, 2020, the IRS announced in Notice 2020-75, 2020-49 IRB that it will issue regulations clarifying that state and local income taxes imposed on, and paid by, a partnership or S corporation may be deducted by the entity and are not subject to the state and local tax (SALT) deduction limitation imposed on individuals. Taxpayers may rely on the provisions in this Notice until the proposed regulations are issued.

IRS Releases Instructions for Fiduciary K-1. The IRS released the 2020 instructions for Schedule K-1 of Form 1041. They detail the new rules for excess deductions upon

[11] *Barefoot v. Jennings*, 8 Cal. 5th 822, 826 (2020)
[12] *Id.* at 827.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.* at 828.

termination of a trust or estate for inclusion on the beneficiary's income tax return.

IRS Approves Certain Electronic Signatures. The IRS Office of Professional Responsibility announced that it has been working to adopt digital signature options. The *Taxpayer First Act of 2019* requires the IRS to provide digital signature options for Form 2848, *Power of Attorney*, and Form 8821, *Tax Information Authorization*, with a secure submission site on IRS.gov beginning in January. In summer 2021, a new platform called the Tax Pro Account is expected to be introduced, allowing tax professionals another secure method to submit these documents.



CALIFORNIA TAX UPDATE
By Katie Lepore, CPA, J.D., LL.M., Taxation

Statewide Proposition Summary. Proposition 22 passed on the November ballot, allowing app-based drivers to be classified as independent contractors rather than employees. Proposition 15, which would have reassessed certain commercial properties every 3 years, failed to pass, as did Proposition 21, which would have provided greater controls to local governments to enact rent control measures.

Local Proposition Summary. In San Francisco, Proposition F passed, increasing the Gross Receipts Tax, and Proposition I also passed, increasing the real property transfer tax rate to 5.5% on property valued over $10 million. Also in San Francisco, Proposition L imposes an additional gross receipts tax on companies where the CEO salary is drastically higher than the average employee wage; the tax rate is dependent upon the ratio between CEO and median employee compensation. Proposition RR increases sales taxes by 0.125% in San Francisco, San Mateo, and Santa Clara Counties to fund Caltrain, passing with a supermajority of over 70% of voters. In Berkeley, Measure GG will levy a rideshare tax on trips originating in the city of up to 50 cents per trip. Long Beach voters approved Measure US which doubles the City's business license tax on general oil production to up to 30 cents per barrel.

Zoom to Collect Communications Taxes. Zoom has recently been sending notifications to customers in four states – California, New York, Maryland, and Virginia – to say that the company will begin collecting state and local taxes as required by local governments, including the California Utility User Tax and Communication User Tax in certain counties and cities, varying between 0.5% to 11%. The tax is expected to estimate 9% in Los Angeles, 7.5% in San Jose, San Francisco, and Oakland, and 6.5% in Sacramento.

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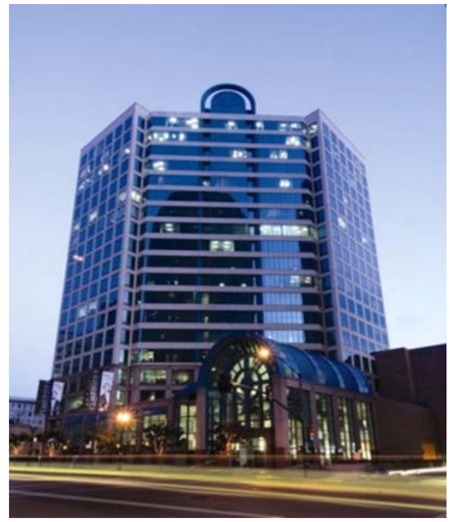

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