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TRANSFERRING REAL PROPERTY: THE PARENT-CHILD EXCLUSION

(*Real Estate Advisory No. 6)*

When planning for the future, most parents want to provide for their children. This often involves passing the family home or real estate investments to the next generation. In doing so, the question often arises of how to do the transfer without triggering an increase in property taxes. This Advisory discusses California's Parent-Child Exclusion[1], which is one method for accomplishing these types of transfers without triggering a reassessment and an increase in property tax.

As a cautionary note, this Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your situation with BFAS or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the distribution of this Advisory.

Introduction. Generally under California law, when a change of ownership of real property occurs via sale or transfer, the property is reassessed at current market value and the new purchaser or transferee is required to pay property taxes based on the newly reassessed value. Given the Golden State's high real estate prices, thankfully exclusions exist that allow for certain transfers of property to occur without being considered a true "change of ownership". Among these is the Parent-Child Exclusion, which allows qualifying transfers of real property between parents and children and, under certain circumstances, from grandparents to grandchildren, [2] to be excluded from reassessment.

Under the Parent-Child Exclusion, parents may transfer principal residences and the first $1 million of real property that is other than a principal residence (or "other property"). Any mode of transfer between eligible children and parents may qualify for this exclusion including: sale, gift, joint tenancy transfer, an inheritance, an intestate transfer, and voluntary and

[1] Note that this Advisory is a simplified discussion of how the exclusion applies and assumes that title is held by the parent in the parent's own name. It does not account for more complex methods of holding title such as in an LLC, trust, etc., and your specific situation may not fall under the application of the Parent-Child Exclusion as discussed.

[2] Grandchildren may qualify for the transfer exclusion when their parents or the middle generation is deceased. They then take in place of their parents. Other rules and restrictions apply in order to qualify these transfers as well, but they will not be addressed in this Advisory.

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involuntary transfers resulting from court order or judicial decree. Transfers from a child to a parent are also subject to this exclusion as long as all of the other eligibility requirements are met. Properties that are transferred to a revocable trust for the benefit of the transferor's child will also likely qualify for the Parent-Child Exclusion as long as the trustee timely files the exclusion claim forms after the parent's passing.

Transferring a Principal Residence. Under this exclusion, a parent may transfer her interest in her principal residence to her child without limitation as to the number of times such a transfer is made or the value of the principal residence transferred. As long as the exclusion claims are timely filed, the exclusion will apply and the property tax will remain the same. The parent may even make multiple transfers of her principal residence to the same child. Meaning that if the mother purchases a new home after transferring her previous one, the she may also transfer the new principal residence to her child and apply the exclusion. The only requirement is that the property qualifies as her principal residence and the exclusion is timely filed. In fact, she can do this multiple times as long as all of the eligibility requirements are met and there is no cap on the value of properties that she can transfer as well.

To give you an example, if Mom decides her house is too big and wants to downsize to a condo, she can transfer her home to her kids Sally and Bob without triggering an increase in property taxes. It does not matter whether this home is worth $500,000 or $2 Million, as long as it is her primary residence, the exclusion will apply. What if, Mom decides she wants to see the Continental 48 before she dies and buys an RV to travel? She may then transfer the condo, her new primary residence, to Sally and Bob using the Parent-Child Exclusion and Sally and Bob will again take ownership without triggering a property tax reassessment. Of course, keep in mind, that this only works if all of the eligibility requirements are met and the exclusion claim is timely filed.

What is a "Principal Residence"? California code defines a principal residence as a property that is *eligible* for either the homeowner's or disabled veterans' exemption as a result of the transferor's ownership and occupancy of the dwelling. This means that the property need not actually be receiving one of these exemptions in order to qualify as a principal residence; it just needs to be eligible to receive one. To provide a better guide of what this means, the State Board of Equalization ("BOE") has defined a principal residence as "a person's true, fixed, and permanent home and principal establishment to which the owner, whenever absent, intends to return." To determine if a property qualifies as a principal residence, the assessor will look for sufficient proof that the property was in fact the parent's primary home, which may include voter or vehicle registration, bank statements, or income tax records. The assessor will also verify that the parent does not have a homeowner's or disabled veteran's exemption on any other property in the state.

Besides having to meet this principal residence definition, the property must also be considered only one "appraisal unit". This means that a parent may only transfer as a principal residence the portion of the land that consists of a reasonable size that is used as a site for the residence itself. Multiple parcels may be considered a principal residence if "the parcels are contiguous and the residence straddles the lot line, thereby making one appraisal unit," but it is up to the person claiming the exclusion to show how the property qualifies. An attorney or other qualified professional should be consulted in such cases to determine how the exclusion may apply.

The $1 Million Exclusion of "Other" Real Property. In addition to a primary residence, a parent may also transfer the first $1 million of full cash value of all real property, other than the principal residence, she owns to a qualifying child without triggering a reassessment. Again, in order for this exclusion to apply, a Parent-Child Exclusion claim form must be filed or the transfer of this other property will not count towards the $1 million exclusion limit.

The "full cash value" transfer limit is determined by looking at the adjusted base year value (also known as the Proposition 13 value) of the property. The assessor looks at the property's value on the date on which a purchase or change of ownership last occurred, or the date on which new construction was completed, plus any adjustments in order to determine the property's full cash value. If the parent has held the property for a while, the full cash value is generally much lower than the current fair market value of the property, which means the property taxes are much lower as well. This means, that a child may receive an investment property from a parent that has a lower assessed value (within the $1 million exclusion limit) and a much higher fair market value, without paying much higher property taxes.

How is the $1 Million Limitation Allocated? Each parent, as an eligible transferor, has a maximum cumulative exclusion limit of $1 million. This means that a father may transfer to his children a maximum of $1 million in other property and a mother may separately transfer to her children a maximum of $1 million in other property to her children without triggering a reassessment. The BOE monitors the $1 million limitation and maintains a state-wide database of transferors who have been granted the exclusion for other real property. When the full cash value of real property exceeds the permissible exclusion, the exclusion is applied on a pro rata basis for property over the exclusion limit. Below is an example from the BOE:

> For example, a parent died and left five parcels of "other" real property to a child. Each parcel had an adjusted base year value of $400,000 for a combined adjusted base year value of $2,000,000. The exclusion cannot be

> applied to only the land of each parcel. Instead, the exclusion can be applied to two parcels (total of $800,000) and half of a third ($200,000). The other half of the third parcel and the remaining two parcels must be reassessed to current market value.

How is the Parent-Child Exclusion Claimed? In order to ensure that the Parent-Child Exclusion is properly claimed, a claim form must be filed within three (3) years after the date of the transfer of real property or before the transfer of the real property to a third party, whichever is earlier. If a claim form is not filed timely, relief can only be granted prospectively if the property is still owned by the transferee.

The preliminary change of ownership form ("PCOR"), which is filed with all transfers of title in California, is not sufficient to grant the exclusion. In order to be valid, the claim form must contain the proper written certification attesting to the parent-child relationship under penalty of perjury from both the transferee and the transferor, or the executors of their estates or their legal representatives. In instances where there are multiple recipients of the transfer, one child may sign on behalf of the other children to attest to the parent-child relationship. However, there is no similar language for transferors. Thus, if there is more than one parent making the transfer, each parent must sign the claim form. Each county generally has their own claim form which may be found on the county recorder's website. If the exclusion is properly claimed, however, in theory, a parent may be able to transfer the property to a child, and then that child may be able to transfer the property to her own child, and so on without triggering a property tax reassessment. Capital gains tax issues may later arise, however, when the last child transferee decides to sell the property.

Caveat Transferor. While transferring property under the Parent-Child Exclusion is a good tool to avoid property tax reassessment, it may not always be the best option for estate planning purposes and for your family. Making an outright transfer of property to a child without any or reduced consideration, will generally qualify as a gift in the eyes of the IRS. This means that the transferring parent will likely have to file a Form 709 Gift Tax Return along with your annual income taxes. If the property interest transferred is valued at or below the annual exclusion limit ($14,000 for 2014 and 2015), then Form 709 does not need to be filed. If, however, the value is greater than $14,000, which is likely given California real estate prices, then the transferring parent will probably have to file Form 709. If the parent has not used up their lifetime gift exemption ($5.43 million in 2015), then the value of the property transferred may be credited towards this limit and no taxes will be owed. Note, that any amount of the lifetime gift exemption that is used will apply to and be subtracted from the estate tax exemption when determining if estate taxes are owed at the time the parent passes away. This means that if a parent transfer's property with full cash value of $1 million but a fair market value of $2

million, the $2 million amount will be used by the IRS to determine the amount of the lifetime exemption remaining. Upon the parent's passing, the parent's estate tax exemption would then be set at $3.43 million (using the 2015 limit), after subtracting the lifetime gift tax exemption. Any assets over this $3.43 million amount would be subject to federal estate tax.

Another consideration is when a parent transfers a property interest to a child as a gift, the child takes the parent's basis in the property, which is important when later calculating capital gains taxes. While transferring the parent's basis is beneficial from a property tax standpoint, if the child decides to the sell the property soon after receiving it, the capital gains tax will be calculated on the full cash value of the property rather than on the fair market value of the property on the date when it was transferred. This is different than other transfer mechanisms, such as joint tenancy or inheriting the property, which allow for a step-up in basis when the property changes hands. If the child receiving the property is planning to eventually sell it, then gifting the property outright may not be the most tax-advantageous solution.

For example, if Mom has a home with a basis of $1 million but a fair market value of $2 million and leaves the home to Sally and Bob in a revocable trust, upon her passing, Sally and Bob will inherit the home with a stepped-up basis of $2 million. If Sally and Bob then sell the home after Mom dies, they will only pay capital gains on the difference between $2 million and the then fair market value of the home rather than on the difference between $1 million and the fair market value of the property if Mom had gifted them the property prior to her death. Plus, Sally and Bob get the benefit of the Parent-Child Exclusion on the property taxes.

Of course, each method of transferring property has its own caveats and considerations. In the end, your ultimate goals and intents for the property should be carefully evaluated before a transfer is made.

Summary. Using the Parent-Child Exclusion is a beneficial tool to help parents transfer their real property holdings to their children without triggering a property tax reassessment. The Exclusion allows a parent to transfer a primary residence or other real property valued up to $1 million of full cash value. Each situation is unique, however, and the exclusion may apply differently depending on how title is held by the parents, how many parcels the property consists of, if the parents or child meet the statutory definition, etc. Also, transferring title to your child outright may also not be as advantageous from a long-term estate planning point of view. If you are contemplating transferring real estate to a child or vice versa, an attorney should be contacted to make sure that no other factors exist that would prevent the exclusion from applying, to evaluate whether this is your best option, and to do the necessary reportings.

As always, you should be sure that additional legislation has not been enacted or that court decisions have been rendered that would change the above advisements. This Advisory is

neither exhaustive nor is it tailored to your specific situation. If you have questions or concerns, you should discuss your individual situation with us or your own attorney.

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This Advisory is one of a series of real estate and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.

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