Lawyers need to know Proposition 13

By Robert W. Wood

California has led the way in many things — some good, some less so. In the tax world, California led the way with unitary taxation for companies operating in multiple states or countries that benefit from California's assets and employees. California also pioneered new ways of collecting state income taxes from people who leave the Golden State for less taxing climes.

And California pioneered the constitutional limit on property taxes. Before Proposition 13, assessments were based on the market value of the property, as determined by appraisal as frequently as every year. With ever-increasing real estate prices and climbing values, property taxes in the 1960s and 1970s grew so quickly that there was a populist revolt.

In 1978, California voters decided enough was enough. On June 6, 1978, two-thirds of California's voters voted to amend the state constitution, cutting the property tax rate from an average of 2.67 percent to 1 percent. What's more, the voters rolled back assessed property values to their 1975-1976 levels. Property taxes fell by roughly 57 percent.

Today, Prop. 13 still dictates that the California real property tax rate is 1 percent of the assessed (market) value plus certain interest and redemption charges for voter-approved bonded indebtedness. These nits aside, Prop. 13 provides security that your base year value — what you paid or what the property was worth in the 1975-1976 fiscal year — can go up only a small amount each year. An increase is allowed based on inflation, but the maximum increase is 2 percent per year, regardless of how much your property appreciates in value.

In fact, the assessor can only reassess and increase the value of your property beyond these amounts when there is: (a) a change of ownership, or (b) completion of new construction. If you wondered why building permits trigger tax assessor look-sees, that's why. Nevertheless, most of the discussion and frequent legal gyrations surround changes in ownership.

Critics of Prop. 13 point out that it shifts the property tax burden from businesses to homeowners. Businesses can more readily avoid changes in ownership, while consumers may have to move every few years for work or family. A "change of ownership" broadly encompasses most any type of sale, gift or transfer, and it will trigger a reassessment unless a transaction is exempt.

In effect, the game in property taxes is about avoiding ownership changes at all costs. Thus, a change of ownership becomes something to be avoided. If you bought your property many years ago, you should be concerned about the property tax impact selling or transferring the property will have.

If you own a home with a low property tax assessment but a high market value, trading up into a new house could result in much larger property tax bills even if the values of the old and new homes are similar. The old property tax assessment is worth something.

Although Prop. 13 was simple when passed, it has gradually become encrusted with many special rules and exemptions. But everyone in California should know about several of them.

For example, you can make a transfer from yourself to a legal entity you own or control.

In addition, most parent-to-child transfers are exempt from reassessment, whether they are made by gift, sale or inheritance. A transfer of a parent's principal residence from parent to child is exempt. The exemption is unlimited so it applies in full regardless of the value of the principal residence.

There is a more limited exemption for parent-to-child transfers where the property is not a principal residence. Here, the exemption applies only for an aggregate of the first $1 million of assessed value of the properties being transferred. The existence of the allowance for parent-to-child transfers causes significant confusion when it comes to mechanics.

For example, it is common for siblings to inherit assets from their parent equally, often as a part of the residuary of their parent's estate. Of three children inheriting equal interests in the family home, only one is likely to want to live there. That child might buy out the other two, either for cash or for a swap of value in other assets in the estate.

But such a transaction does not keep the property tax value the way an outright bequest from parent to child would have done. This problem with residuary bequests, exacerbated by having more than one child, is best solved by planning and specific bequests of property. Of course, the problem is most severe when the Prop. 13 assessment is low, which makes perpetuating that assessment quite valuable.

Many children hoping to keep a low property tax assessment have been tripped up by this rule. Sibling-to-sibling transfers are not entitled to the exemption afforded to parent-to-child transfers. Without proper planning, an inherited property may only be partially exempt from reassessment.

How much is a low property tax exemption worth? Bear in mind that unless you sell the property, it is a renewable resource, saving you money each year into the future.

There are other Prop. 13 exemptions, too. For example, there is an exemption for persons aged 55 or over, or persons severely and permanently disabled. Such homeowners can transfer the assessed value of their principal residence to a replacement property of equal or lesser value. There are rules, however.

For example, the replacement residence must be within the same county as the original residence or in another county that has adopted a relevant participating ordinance. The qualified replacement property must be purchased or newly constructed within two years of the sale of the original residence. Finally, this exemption can be used only once in a lifetime.

Prop. 13 is surprisingly complex, and this article barely scratches the surface. Be careful and sweat the details. The dollars you save for you or your client may be significant. If you succeed in saving them, you can reap the reward every year.

Robert W. Wood *is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*