**PROPOSITION 19 SOLUTIONS**

**DISCLAIMER and WARNING**

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**THE SOLUTIONS**

Time is running out for those of you who want to do something before the law changes on February 16, 2021. We want to give you an opportunity to make a reasonable and informed decision about whether to do anything, and if so, what to do. Not everyone needs to do something about the change.

In general, you DO NOT need to do something IF:

* You don’t have children.
* You just don’t want to do something about it (my favorite reason).
* Your children are likely to sell the property after you pass.
* You are likely to sell the property during your lifetime.
* You are ok with your children paying higher annual property taxes after you pass.

In general, IF you do NOTHING you WILL:

* Keep your lower proposition 13 tax benefits during your lifetime. Your kids will still be able to inherit the property after you pass. The property taxes are increased only AFTER you pass.
* Keep all the benefits of your Living Trust planning you have already done (assuming you have kept the Living Trust properly funded and up to date).

We are writing this letter with the assumption that you have previously viewed our live webinar recording and/or understand the basic concepts of Proposition 19, Proposition 13 and Proposition 58. If you have not viewed that webinar, please do so now.

<https://zoom.us/rec/share/7XyH11bo9KxHP7gl1nxMD49pIFMI-0xI7K-Gf3HcIrypf0oDwISKZhf8VISCjos.R9iNVvDwnzMy4MdM?startTime=1608174070000>

All solutions, whether simple or complex, come with significant risks and/or sacrifices. There are some complex solutions that keep most of the benefits that your children would have had, if not for the passing of Prop 19, and provide many of the protections and benefits you currently have. Our desire is that this letter will help you understand the difference between the simple and complex solutions. This is not an exhaustive analysis of every possibility, aspect or consideration.

**For reasons that will become apparent (e.g., your security and the downsides related to the Simple Solutions), we advise all clients to consider the**

**Complex Solutions towards the end of this discussion.**

But first, simple questions with simple answers:

* Why doesn’t my Living Trust protect Prop 13? It does, while you are alive, you keep Prop 13, for yourself. However, you are the *current beneficial owner* of property in your Living Trust. This means Prop 13 is currently yours. Only after you pass away will your children become the current *beneficial owners*. If you don’t pass away before February 16, 2021, the children will inherit under the new rule (Prop 19) and be re-assessed accordingly.
* What do I have to do to keep Prop 13 for my kids? They need to be the *current beneficial owners* of the property now, before February 16, 2021.
* Can I just amend my Living Trust to make my children the *current beneficial owners* of the property before February 16, 2021? No. Your current revocable living trust does not give anything away until *after* you die, and that’s non-negotiable.

This letter is written from the perspective that the goal is to include the property (and the appreciation in its value) in your estate when you pass away for the purpose of getting a step up in the cost basis. Further analysis is necessary if your estate is large enough now that we may not want the property included in your estate.

**SIMPLE SOLUTIONS**

1. **No Strings Attached – Give it to the Kids Now**

Transfer the property into the names of your children now, before February 16, 2021, with no strings attached, and claim the current, more generous exemption for parent to child transfers. Your children would own the property now and maintain Prop 13 after you pass. You would have **no rights** in the property whatsoever.

This *No Strings Attached* solution comes with significant risks, negative income and estate tax consequences:

* Can my children kick me out and/or sell my home? Hopefully they would not, but yes, they could. You would not have the right to live in your own home if your children don’t let you.
* Right to the Income and Income Tax Deductions? You would not be entitled to the income generated by the property. Your children are the ones entitled to the income tax deductions/write-offs.
* Control? You would have no control over that property.
* Asset protection for you from your children’s creditors, spouses, future spouses, conservators, executors? None.
* What if I need to sell the property? That’s up to your kids; it’s not your property anymore.
* Who pays the capital gains taxes if the house is sold? Your kids. If I end up needing to sell the property, do I get the capital gains tax exemption ($250,000 exemption) because it is my primary residence? No, it’s not your property anymore.
* Can I take out a loan on the property? No.
* Estate Inclusion? Will my kids get a new cost basis after I pass away? No. Since you will not be treated as the owner of the property for estate tax purposes, your children will not get the step up in the cost basis.
* What happens if my child passes before me? The percentage owned by that child would be re-assessed and the property taxes would go up (unless it qualified for an exemption from re-assessment; i.e., if their spouse was to inherit that child’s share).
* What if I have a loan or mortgage on the property? If your cost basis is less than the outstanding debt you may be taxed for the difference between the loan and the cost basis. Why?  Because you unburdened yourself of the mortgage by giving the house away, and that amount is taxable.
* Do I have to file a Gift Tax Return? Yes, if you make a taxable gift, even if no gift tax is due, of more than the $15,000 exclusion amount. Even though there is a gift tax exemption of several millions of dollars before you actually have to pay any gift tax, you still have to file the gift tax return. If you are married you both have to file separate returns.
* Do I have to have the Property Appraised? Yes, because you have to file a gift tax return, you should report the fair market value of the gift by obtaining a certified appraisal of the property by a licensed appraiser.

1. **A Few Strings Attached – Sell it to the Kids (and Lease it Back, if it’s Your Residence)**

***For Income Property*** - Sell the property to the kids in exchange for a Promissory Note (Secured by Deed of Trust) equal to the fair market value of the property and claim the exemption for parent to child transfers before February 16, 2021. The children would own the property now. The children would be taxed on the income of the property. The kids could sell the property, but you would be entitled to reimbursement for the balance of the loan. The property would still be generating income, although you would have no control over the management of the property, and the children would be entitled to the income and be paying you back on the promissory note. The kids would pay the tax on the income. You would also have to pay some income tax on the interest generated by those payments the children are making to you on the promissory note.

***For Your Personal Residence*** - Sell the property to the kids in exchange for a Promissory Note (Secured by Deed of Trust) equal to the fair market value of the property and leaseyour property back from them for fair market rent and claim the exemption for parent to child transfers before February 16, 2021. The children would own the property now. You would have the right to live in the property under the lease, but you would have to pay rent under that lease. The children would be taxed on the rent payments as income. The kids could sell the property, but you would be entitled to continue living there under the lease agreement and reimbursement for the balance of the loan. You would be paying on the lease, and the children would in turn be paying you back on the promissory note. You would also have to pay some income tax on the interest generated by those payments the children are making to you on the promissory note.

This solution comes with significant risks, negative income and estate tax consequences.

* Can my children kick me out and/or sell my home? If you keep up the formalities of paying the rent as agreed, then they could not. They could sell your home and you would be paid back what was due on the promissory note and have a new landlord.
* Right to the Income and Income-Tax Deductions? You would not be entitled to the income generated by the property. Your children are the ones entitled to the income tax deductions/write-offs. You would be entitled to the income owed to you under the promissory note. You would be responsible for paying income tax on the interest generated on the promissory note. You would probably recognize a gain for the sale of the property, if it’s been a while since you bought the property yourself, and have to pay capital gains taxes for everything over your cost basis.
* Control? You have the right to live there under the lease and, if the house is sold, a right to reimbursement under the promissory note.
* Asset protection for you from your children’s creditors, spouses, future spouses, conservators, executors? None of your children would have any protection, except for umbrella policies that they might have. You would only be protected to the extent you have the right to live there under the lease and, if the house is sold, a right to reimbursement under the promissory note.
* What if I need to sell the property? That’s up to your kids; it’s not your property anymore. Who pays the capital gains taxes if property is sold? Your children; but they would only owe capital gains taxes on the appreciation of the property since the time they bought it from you. If I end up needing to sell the property, do I get the capital gains tax exemption ($250,000 exemption) because it is my primary residence? No, it’s not your property anymore.
* Can I take out a loan on the property? No, it’s not your property anymore.
* Estate Inclusion? Will my kids get a new cost basis after I pass away? No, you will not be treated as the owner of the property for estate tax purposes, and your children will not get the step up in the cost basis.
* What happens if my child passes before me? The percentage owned by that child would be re-assessed and the property taxes would go up (unless it qualified for an exemption from re-assessment; i.e., if their spouse was to inherit that child’s share).
* Do I have to file a Gift Tax Return? No, IF you have the property appraised by a licensed appraiser and you sell the property to the children for that amount. Yes, IF you sell the property for less than the fair market value and the difference is more than the $15,000 annual exclusion amount.
* Do I have to have the Property Appraised? Yes.

1. **Transfer Ownership of the Property to an Irrevocable Trust Held for the Children as *Current Beneficial Owners***

Transfer the property to an Irrevocable Trust that names your kids as the *current beneficial owners* of the property and claim the exemption for parent to child transfers before February 16, 2021. You could be the Trustee but not the beneficiary. This means you owe a duty to the beneficiary (i.e., the kids) to produce income on the property for them and not for yourself. The children would be entitled to the income, including a right to the income that *should be* generated on your personal residence, which means you should be paying rent. They would be taxed on the income, and you would have to pay the income (i.e., the rent) to them. If you didn’t, they could rightly sue you (or their creditors, heirs, conservators, executors, etc. could sue you). We cannot simply create an Irrevocable Trust that makes *them* the beneficiaries for California property tax purposes and makes *you* the beneficiary for every other reason. Also, the income rights and tax issues are similar to those discussed in the *no strings attached* solution discussed above (please review those). So, we need more than just an Irrevocable Trust to address issues such as your rights to the income, income tax treatment, getting estate inclusion and the step up in the cost basis, etc.

This solution comes with significant risks, negative income tax- and estate tax consequences.

* See the “No Strings Attached” significant risks, negative income and estate tax consequences (above). The main difference is that you would actually be the Trustee of the Irrevocable Trust, however, all other significant risks, negative income and estate tax consequences listed under the “No Strings Attached” remain the same for this solution.

**COMPLEX SOLUTIONS**

**1. Transfer 100% Ownership of the Property to an Irrevocable Trust in Exchange for a Promissory Note (Secured or Unsecured by Deed of Trust) (with a Leaseback, if the property is your Primary Residence)**

Transfer/Sell the property to an Irrevocable Trust that names your kids as the *current beneficial owners* of the property in exchange for a promissory note (secured or unsecured by deed of trust) and claim the exemption for parent to child transfers before February 16, 2021. You can be the Trustee of the Trust, but not the beneficiary. This means you owe a duty to the beneficiary (i.e., the kids) to produce income on the property for them and not for yourself. The children would be entitled to the income, including a right to the income that should be generated on your personal residence. Which means you should be paying rent, which you will under the lease. However, like in the Simple Solution *Sale and Leaseback*, you are owed a lot of money (the full value of the property) from the sale. Thus, income earned by the property is due back to you, *in the form of repayments on the promissory note*. So, while the property is producing income, you will be **“***getting that income back***”** through the payments on the promissory note owed to you by the Irrevocable Trust. The type of trust we would set up allows you to remain the taxpayer for income tax purposes, which means, there will be no income tax consequences for this sale. Your children will not be taxed on the income from the property (you will continue to be taxed on the income, *if it’s a third-party rental*). You will not pay tax on your own lease payments (in the case of the leaseback of your personal residence) and neither will your children. You will not be taxed on the interest payments due on the promissory note.

This solution still comes with significant risks.

* Can my children kick me out and/or sell my home? No, they could not kick you out or sell the property. Moving out or selling the property would be up to you (when and if you wanted to).   You would be the Trustee (manager) of the Irrevocable Trust. You should keep up the formalities of paying the rent as agreed under the lease and keep records of the payments made by the Irrevocable Trust on the Promissory Note.
* Right to the Income and Income-Tax Deductions? While you would not be directly entitled to the income generated by the property, you would be entitled to the income owed to you under the promissory note. You would be entitled to the income tax deductions/write-offs. You will not have to pay income tax on the interest generated on the promissory note. You will not recognize a gain for the sale of the property and will not have to pay capital gains taxes for everything over your cost basis.
* Control? You would be the Trustee (manager) of the Irrevocable Trust. As an individual, you have the right to live there under the lease, and if the house is sold, you have a right to reimbursement under the promissory note. Similarly, you have the right to income on income-producing property under the promissory note. Even if sold, you are still the Trustee (manager) of the irrevocable trust and could continue to manage the investments of the proceeds of the sale or use the proceeds of the sale to purchase new real property.
* Asset protection for you from your children’s creditors, spouses, future spouses, conservators, executors? While you are alive and owed back money under the promissory note, the Trustee (i.e., you) would allow for restrictions on distributions from the Irrevocable Trust to the beneficiaries: basically, allowing for the prevention of paying claims against your child’s share of the Trust. However, as is always the case, once property is actually distributed to the beneficiary, it is then up to the beneficiary to protect those assets from their creditors. One solution, for after you pass away, is to continue the trust on in existence through your children’s generation, continuing to protect the assets.
* What if I need to sell the property? That’s up to you, as Trustee. Who pays the capital gains taxes if I need to sell during my lifetime? You, as an individual. If I end up needing to sell the property, do I get the capital gains tax exemption ($250,000 exemption) because it is my primary residence? Yes.
* Can I take out a loan on the property? Probably not.
* Estate Inclusion? Will my kids get a new cost basis after I pass away? Yes, you will be treated as the owner of the property for estate tax purposes, and your children will get the step up in the cost basis.
* What happens if my child passes before me? The percentage owned by that child would be re-assessed, and the property taxes would go up (unless it qualified for an exemption from re-assessment; i.e., if their spouse was to inherit that child’s share). For example: What happens if you named 3 children as current beneficiaries of the Irrevocable Trust and one passes away before you? One-third of the property would be re-assessed. The use of a legal entity could help mitigate the risk of reassessment upon the death of a child.
* Do I have to file a Gift Tax Return? No. You have the option to file if you want to insure that the IRS has been put on notice of your intent that the property be included in your estate.
* Do I have to have the Property Appraised? No. Although, we should be relying on credible information in our value assumptions. You may want to get a letter from a real estate broker stating what they think the value is. If you do choose to file a gift tax return, then yes, you will need to have the property appraised.

**2. Transfer 1/2 Ownership of the Property to an Irrevocable Trust in Exchange for a Promissory Note (Secured or Unsecured by Deed of Trust) (Leaseback if on Primary Residence)**

Step 1: Transfer/Sell only half (1/2) the property to an Irrevocable Trust in exchange for a promissory note (for ½ the fair market value; secured or unsecured by deed of trust) that names your kids as the *current beneficial owners* of the property and claim the exemption for parent to child transfers before February 16, 2021. Your children will get your Prop 13 on that half. What do we do about the other half? You keep the other half in your Living Trust.

Step 2: Create a qualifying legal entity – e.g., LLC (Limited Liability Company) or General Partnership.

Step 3: Transfer both halves to the LLC or General Partnership (1/2 owned by the Irrevocable Trust and the 1/2 that you own in your Living Trust). Now the “legal entity” rules apply to the property. The rules for changes to property taxes are different for legal entities than for individuals owning property. There is no reassessment if no more than 50% of the LLC or General Partnership ownership changes and no one gains control (i.e., 50% is not a controlling interest but 51% is).

Why do it this way? Several reasons:

The main reason is you maintain part ownership of the property (50%). That helps (not necessarily solves the problems) with a lot of the practical issues (i.e., loans, obtaining them, keeping them; sense of control and comfort; you can change the beneficiaries on the 1/2 you still own in your Living Trust). If one of your children were to pass away before you (assuming you have more than one child) the property would not be reassessed because the *legal entity rules* apply and not the individual ownership rules.

For estates that are approaching, or are likely to approach, the estate tax exemption, this hybrid version allows for the actual gifting (should you decide to do so in the future) of the remaining 50% of the LLC or GP owned by the Living Trust. Gifting the half interest in the LLC or GP comes with it significant discounted valuations (reducing the impact gift and estate tax consequences if you decide to later gift the half ownership). Further legal advice will be necessary prior to making such a gift in the future.

This solution still comes with significant risks:

* Can my children kick me out and/or sell my home? No, they could not kick you out or sell the property. Moving out or selling the property would be up to you (when and if you wanted to). You would be the Trustee (manager) of the Irrevocable Trust which owns 50% of the LLC or General Partnership (“GP”) and thus a manager of that legal entity. You would also be the manager of the half of the LLC or GP that you own under your Living Trust. You should keep up the formalities of paying the rent as agreed under the lease and/or keep records of the payments made by the Irrevocable Trust on the Promissory Note.
* New Tax Return? An LLC carries with it a minimum tax of $800 per year (the tax could be more than $800\*) paid to the State of California. A discussion with your CPA or accountant should be had regarding the tax and filing ramifications before deciding on an LLC or a General Partnership. A General Partnership does not have that minimum tax. The LLC needs to file its own CA and Federal tax returns. There is a partnership return required to be filed in CA.
* Right to the Income and Income-Tax Deductions? The ½ you own is just like it was before. The other half owned by the Irrevocable Trust is the same as stated in Complex Solution 1 above, while you would not be directly entitled to the income generated by the property, you would be entitled to the income owed to you under the promissory note. You would be entitled to the income tax deductions/write-offs for the income generated by the property. You will not have to pay income tax on the interest generated on the promissory note that the Irrevocable Trust owes back to your Living Trust. You will not recognize a gain for the sale of the property to the Irrevocable Trust and will not have to pay capital gains taxes for everything over your cost basis.
* Control? You would be the Trustee (manager) of the Irrevocable Trust which owns 50% of the LLC or General Partnership (“GP”) and thus a manager of that legal entity. You would also be the manager of the half of the LLC or GP that you own under your Living Trust. You should keep up the formalities of paying the rent as agreed under the lease and/or keep records of the payments made by the Irrevocable Trust on the Promissory Note. You would also need to follow the formalities required for the LLC or GP.
* Asset protection for you from your children’s creditors, spouses, future spouses, conservators, executors? The LLC will provide more protection than a General Partnership (a General Partnership provides no limited liability component as the LLC does). While you are alive and owed money under the promissory note, the Trust, would allow for restrictions on distributions to the beneficiaries; basically, allowing for the prevention of paying claims against your child’s share of the Trust. However, as is always the case, once property is actually distributed to the beneficiary, it is then up to the beneficiary to protect those assets from their creditors. One solution, for after you pass away, is to continue the trust on in existence through your children’s generation, continuing to protect the assets.
* What if I need to sell the property? That’s up to you. Who pays the capital gains taxes if I sell? You. If I end up needing to sell the property, do I get the capital gains tax exemption ($250,000 exemption) because it is my primary residence? Probably not since it is owned by the legal entity not you, but maybe (remember, you don’t want to do this planning if you are likely to sell the property during your lifetime).
* Can I take out a loan on the property? Much more likely (not guaranteed) since you still maintain ownership of 1/2 the property.
* Estate Inclusion? Will my kids get a new cost basis after I pass away? Yes, you will be treated as the owner of the property for estate tax purposes, and your children will get the step up in the cost basis.
* What happens if my child passes before me? If that happens (assuming you had more than one child) you would not be re-assessed. We will want to make some changes at that time before you pass away (unless the new *current beneficial owner* qualified for an exemption from recognizing a change in the owners of the LLC or GP for property tax purposes). We would need to take the property out of the LLC or GP at that time and put it back into the same or a new LLC or GP. If more than 50% of the ownership changes, or someone gains control, directly or indirectly, of the LLC or GP, then 100% of the property will be re-assessed. When you pass away, 50% of the ownership will have changed, we will need to take the property out of the LLC or GP and put the ownership back to ownership by the Irrevocable Trust and your Living Trust before distribution to your children. You should not do any of this without legal representation.
* Do I have to file a Gift Tax Return? No. You have the option to file if you want to insure that the IRS has been put on notice of your intent that the property be included in your estate.
* Do I have to have the Property Appraised? No. Although, we should be relying on credible information in our value assumptions. You may want to get a letter from a real estate broker stating what they think the value is. If you do choose to file a gift tax return, then yes, you will need to have the property appraised.

\*LLC fee

If your LLC will make more than $250,000, you will have to pay a fee. LLCs must estimate and pay the fee by the 15th day of the 6th month, of the current tax year.

| California income rounded | |
| --- | --- |
| **If the total California income rounded to the nearest whole dollar is:** | **The fee amount is:** |
| $250,000 - $499,999 | $900 |
| $500,000 - $999,999 | $2,500 |
| $1,000,000 - $4,999,999 | $6,000 |
| $5,000,000 or more | $11,790 |