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Taming Your Property Taxes

Restructuring Strategies for Long Term Property Tax Savings

The preceding chart provides a graphic depiction of data relevant to property tax assessments based on the example of a property (or group of properties) reassessed in 2005 for $5,000,000 with a current fair market value of $3,000,000. Various strategies can be implemented to produce long term property tax savings, to increase the parent-child exclusion from reassessment from $1.0 million to $1.99 million (or from $2.0 to $3.98 where both parents are involved), or even to completely avoid reassessment on a purchase given the right circumstances and strategies. The gold standard is reached when property owners achieve the best combined Income Tax, Estate Tax, and Property Tax results while building structures for long term wealth management and preservation. This memo focuses primarily on property tax issues.

The attached chart shows three data sets. First the data depicted by the blue line reflects the adjusted value of the properties commencing with the $5.0 Million "Base Year Value" occurring in 2005 and adding the maximum 2% annual increase each year thereafter to establish the "Factored Base Year Value." The Factored Base Year Value is the amount used by the Assessor to determine the maximum taxable value allowed under Proposition 13 in any succeeding year. The data depicted by the blue line is referred to as the "2005 Factored Base Year Line".

The data set represented by the red line assumes a new purchase or change in ownership has occurred in 2009 which establishes a new base year value based on the market values of the Property (or Properties) of $3.0 Million. Annual adjustments are made each year starting in 2009 based on the 2% maximum adjustment from that base year to establish the new maximum Factored Base Year Values each year thereafter. The data set on the red line is referred to as the "2009 Factored Base Year Line".

Finally, the (more volatile) data set depicted by the green line on the chart is a guesstimate of fair market values projected year to year into the future through the year 2030. The data set on the green line is referred to as the "Market Value Line".

Property taxes are determined based on the lesser of Factored Base Year Value or Fair Market Value. So the property tax in any given year depends on whether the Fair Market Value exceeds the Prop 13 “Factored Base Year Value.” Market Values are used for the assessment whenever the fair market value of a property is below the Prop 13 Factored Base Year Value and the Factored Base Year Value is used for the assessment whenever the factored value is below Fair Market Value. In other words, the 2% annual limitations on increases in assessed values under Proposition 13 only apply when Fair Market Value exceeds the Factored Base Year Value.

Most adjustments to assessed values for purposes of property tax appeals and claims of refund are temporary in nature. Changes as a result of a formal or informal assessment appeal (such as a “Decline in Value Adjustment” available under Proposition 8 or an “Application for Changed Assessment”) are based on current year declines in value and are only temporary adjustments. In other words, temporary changes in assessed values are subject to significant annual increases. Year over year increases can be well above the 2% cap until the property’s fair market value once again meets or exceeds the “Factored Base Year Value.”

While it may seem distant at present, in a real estate recovery, it is not unexpected to see assessed values increase on a year over year basis well in excess of 5, 10, or even 20%, particularly if the property in question is one originally purchased in the high value era (2000-2007) which has a Base Year Value set during an inflated market period such as in 2000-2007. It may take some time, but eventually market values will again exceed the 2005 Base Year Line. In the meantime property owners have a great opportunity to mitigate property taxes on a long term basis if one acts while the market is still low.

The chart and attached computations reflect the long term property tax benefits which can be achieved in the event of a permanent change in ownership which triggers a new Base Year Value. In comparison with more temporary adjustments achieved on as informal or formal assessment appeal (such as the “Decline in Value Adjustment” under Proposition 8) a change in ownership in the right circumstances can result in long term property tax savings. In the example of a property (or properties) worth $5.0 million in 2005 and $3.0 million currently, the long term savings can amount to over $35,000 per year.

During the economic downturn many assessors have voluntarily or under threat of appeal agreed to reduce assessed values. In some cases they have reduced values all the way down to current fair market value, but in most cases the assessed values still exceed current market values. The informal assessor adjustments, decline in value adjustments and even adjustments made in a formal assessment appeal (Application for Changed Assessment) are all temporary adjustments only. Even if appealed, the decrease resulting from an assessment appeal only results in a temporary reduction to the assessed value, not a permanent change to the Base Year Value which is the starting point for all future assessments under Prop. 13.

In contrast, a change in ownership in the right circumstances creates a permanent new base year value for purposes of Proposition13 and sets the property owner permanently on a lower Factored Base Year Value trend line as illustrated by the red line in the attached chart.

If a change in ownership does not occur, then the blue line will represent the maximum assessed value under Proposition 13 that will be in effect each year under current law until a change in ownership occurs, except those years in which the fair market value is lower than the Factored Base Year Value.

A change in ownership can be accomplished in some cases by changing ownership within a group of related entities, by structuring certain types of leases, by using life estates, by using certain types of trusts to own property, or by using a combination of these structures. Very specific requirements must be met with each type of change in ownership and each type of change in ownership has different income tax, estate and gift tax, and legal ramifications which should be understood before the change is made. Many complications can arise and the discussion below only mentions some of the most obvious problems.

The projected property tax savings computed on the following table are based on the data assumptions used for purposes of the illustration in the chart. The computation compares the difference between property tax (at 1% rate) using 2005 Base Year Line in comparison with the property tax calculated using the 2009 Base Year Line for assessment purposes (and assuming a 1% flat property tax rate without any additions for special assessments, etc.). In some years the property tax would be computed based on the green line (the Market Value Line).

The actual property tax for a property or group of properties that isn't reassessed at the 2009 or later level due to a change in ownership would actually adjust with more volatility year over year as fair market values change. This is represented by the green line in the chart. The assessor will use the fair market value on such properties once again exceeds the Factored Base Year Value represented by the 2005 Base Year Line.

So without a change in ownership, property tax assessed values over a period of years is a blend using actual fair market values in years where the Market Value Line (green line) is lower than the blue 2005 Base Year Line. Assessed values would use the maximum prop 13 value on the blue 2005 Base Year Line when actual fair market values exceed the 2005 Base Year Line (exceed the Prop 13 Factored Base Year values). Thus property tax assessments will increase back to the 2005 Base Year Line once fair market values recover to that level.

Based on the example of a \$5.0 million property now worth \$3.0 million, <u>projected annual property tax savings once the fair market value starts to recover can exceed \$30,000 per year</u>. For purposes of the graph, I've estimated fair market value will once again exceed the 2005 Base Year Line in about the year 2018. The green line is a guesstimate of future fair market values only and actual values will differ from the projection.

Various strategies can be used to produce a change in ownership under R&TC Sections 60-65. Such a change should not be made if tax reasons are the sole motivation, but there are a number of business purposes that might make a change beneficial, including changes relating to your estate planning, business planning, loan restructuring, wealth preservation and business succession planning.

Restructuring a property holding must be approached with caution and all the relevant facts and circumstances considered, including issues involving lenders (acceleration of loans on transfer), co-owners, asset management and control, liability issues, community and separate property issues, income tax ramifications on a transfer, and other relevant legal issues. Special understanding of the application of tax doctrines such as the "step transaction doctrine" and the "substance over form" doctrine must be considered as California Tax Law allows assessors to apply these doctrines to property transactions. The property owner should seek professional advice on how to handle such transactions to reduce the risk of an unfavorable application of one of these doctrines.

Many strategies can be developed with thoughtful use of the basic rules. For instance, you can leverage the $1.0 million parent-child exclusion into a $1.99 million exclusion (or if two parents are making transfers, a $2.0 million parent-child exclusion can be leveraged to $3.98 million) in the right cases. In other circumstances, new properties can be acquired without triggering a reassessment if the acquisition is structured properly (as recently done by the Gallo family in purchasing the Louis Martini winery and vineyards.

Complications may arise based on a number of issues, including income tax issues, liability issues, lender issues, co-ownership issues, etc. For instance, most loans have anti-assignment provisions. If the property is distressed, the lender may not cooperate and may consider the transfer of the property to a new entity to be a violation of loan covenants. Most lenders we have dealt with have been cooperative when the goals are explained, but some have sought adjustments to loan terms, including increased interest rates for loans secured by properties that are "underwater." In those circumstances where the lender doesn't wish to participate, other structures can be used which may qualify as a change in ownership but which would not violate the loan covenants.

For income tax purposes the potential for recognition of income should be considered such as in some cases where liabilities assumed exceed tax basis or if there is a cancellation of all or a portion of the debt on the property. The income tax issues pose a particular trap for the unwary.

Nevertheless, there are numerous legal precedents which can be followed to safely maneuver around the issues when dealing with a knowledgeable professional and having a legitimate business or estate planning purpose to pursing a change in ownership.

BIO: Scott G. Beattie, JD, LLM (Tax) is a Partner at Beattie & Aghazarian, LLP and a Certified Specialist in Estate Planning, Trust and Probate Law. Mr. Beattie wrote a thesis paper on Property Taxation in Estate Planning Transactions in 1996 for his Master of Laws Degree (LLM) in Taxation and has made numerous presentations on the subject to or in association with the Bank of Agriculture and Commerce (BAC), Bank of the West, the California Rental Housing Association, CB Richard Ellis (Stockton and San Jose), the Institute for Real Estate Managers (Bay Area Chapter, presentation at the Silicon Valley Capital Club), Lee and Associates, the Financial Planning Association of San Joaquin County, and various other organizations. Mr. Beattie can be reached at

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