

The Property Tax Trap for Unmarried Couples and Avoiding the Pitfalls of Property Co-Ownership

February 2016

**By Alma Soongi Beck, J.D., LL.M. Taxation, Certified Specialist, Estate Planning,
Trust and Probate Law, State Bar of California, Lakin Spears LLP**



Real estate professionals beware: Your clients who are not married to each other and who are not registered with each other as California state domestic partners ("SRDPs") have a tremendous opportunity to avoid property tax problems later, just by how they go on title before the sale closes. But the opportunity may be lost after initial closing, and might not be fixable later.

The issue is property tax reassessment. California state property taxes have been governed by Proposition 13 since 1978, which sets the "assessed value" of the property at the acquisition value, and only increases by 2 percent a year until the property undergoes a change of ownership. "Assessed value" is the amount used to calculate property taxes, for state, county and local tax purposes. So when the property undergoes a change of ownership, typically by sale to a new owner, and if the property value itself has appreciated more than 2 percent a year, reassessment can result in a huge increase in the property taxes for the new owner.

Change in ownership also occurs at death, which is where co-owners can get burned without realizing it.

Thankfully, a transfer between spouses or between California state registered domestic partners ("SRDPs") is not considered a "change of ownership" for property tax purposes. Also excluded are some transfers between parent and child, and less frequently, between grandparent and grandchild. So basically if my SRDP or spouse has a property with a \$100,000 assessed value (e.g., purchased decades ago, or inherited from parents under the parent-child exemption), and I then inherit it when its value has increased to \$1,000,000, my property tax would stay the same upon inheritance, under the spousal or SRDP exemption from reassessment. However, if we are not married and not SRDPs, the property would be reassessed 100%, and would then increase ten-fold, unless we fell under one of the other exemptions discussed below.

This issue can be quite serious for couples who are not married and not registered as SRDPs, sometimes resulting in a surviving owner who may be retired and on a fixed income, who then no longer can afford to live in the property. All this at just the time the surviving owner is grieving for their beloved co-owner (or life partner).

The good news: there is hope. However, action is required either before closing on title, or afterward, as described below. **IMPORTANT:** Both rules below require that a co-owner's share be completely inherited by the other co-owner upon death.

(1) The 2013 Co-tenancy Rule, AB 1700.

As of January 1, 2013, AB 1700 amended Section 62.3 of the Revenue and Taxation Code, permitting a surviving co-owner to avoid reassessment if all the following conditions are met:

- (a) Only two owners (or "co-tenants") had owned the property before death, and together they owned 100 percent of the property;
- (b) Transfer of property results from the death of an owner, and after transfer, the remaining co-tenant owns 100 percent of the property (by inheritance through will or trust, or by joint tenancy right of survivorship); and
- (c) Both co-tenants had lived in the property as a primary residence for at least one year prior to the death of an owner (which needs to be provided by signed affidavit upon death of a co-owner).

On the positive side, this rule should protect most co-owners of property who are not married or SRDPs with each other. However, there are some notable cases where this rule will provide no protection, including but not limited to:

- (i) Property involving more than two co-owners, such as multi-unit tenancy-in-common buildings (e.g., in San Francisco) where strangers get together and share ownership on one deed, and then agree in a separate written agreement who occupies which unit and how common areas will be managed;
- (ii) Second residences, vacation homes, and rental property;
- (iii) Property where only one person is on title.

The last issue can be resolved if the person on title is willing to add the other (such as their unmarried partner) to title, which can be done in small percentages if needed. However, be aware that adding someone to title even as a 1% owner can significantly compromise an owner's control of the property. For instance, if the 1% owner objects to sale, the 99% owner will not be able to sell without protracted legal action. Also, even a 1% transfer would itself

trigger a 1% property tax reassessment and/or federal gift tax filing objections (or payments), and either way, should be done in conjunction with a written property co-ownership agreement that outlines obligations and rights of reimbursement. Finally, even a 1% interest in real property can trigger a probate at the death of the 1% owner, which raises the issue of whether to set up or update one's revocable living trust to ensure the other owner inherits that share.

In sum, please seek legal counsel if you think you want to add someone to title, and consider setting up a written property agreement as well.

(2) The 2003 Joint Tenancy Transfer Rule 462.040.

While the Cotenancy Rule will help many co-owners who are not married or SRDPs with each other, in those cases where the rule will not apply, as described above, another option is available. **However, this option usually requires particularly attention before the property closes upon original purchase.**

Property Tax Rule 462.040 was expanded on November 13, 2003 in a way to allow co-owners not married to each other to avoid reassessment upon the death of an owner, for the first time in California history. Specifically, the expanded rule allows an exemption from reassessment for transfer from two or more co-owners holding property as tenants in common to those same co-owners as joint tenants.

When couples properly understand the rule, usually upon consultation with legal counsel, they can qualify for the exemption directly upon acquisition of a new property. Basically, if a couple acquires property as tenants in common, and then immediately transfers to themselves a joint tenants, they are then protected from future reassessment upon death of a co-owner, and potentially also in the event of buy-out.

The rule seems simple, but it requires some important advance planning:

- (a) The rule requires a series of transfers, which ends up in joint tenancy, which is, by definition, equal ownership with an automatic right of survivorship at death. So if the owners do not want to inherit from each other, this option will not work. Moreover, if the owners do not want to divide the proceeds of the property in equal shares upon sale or buy-out later, or want to provide for a right of reimbursement for certain unequal contributions, they will at least need a written property co-ownership agreement to protect their interests.

- (b) The owners cannot initially start in joint tenancy, which is most commonly how unmarried couples will go on title in the absence of proper legal counsel. Some people argue that you can transfer from joint tenancy to tenancy in common (which has no right of survivorship) and then back to joint tenancy, but this violates the well-known tax doctrine called the “step transaction doctrine” which states that you cannot just go in a circle with your transfers if the sole reason is to avoid taxes.
- (c) The owners cannot transfer their joint tenancy interest into a Trust. That transfer will disqualify them from this rule. This last result is rather counter-intuitive, because most trusts and estates attorneys would recommend transferring all other real property interests into a revocable living trust in order to avoid court-supervised probate and to create other tax and creditor protections for people inheriting the property.

NOTE: The 2003 expansion also allowed for an exemption for transfers between 2003 and 2013 from joint tenancy into revocable trust. That exemption is still available for those transfers that occurred during that time period, but not for any such transfers that occurred before enactment of the rule on November 13, 2003, or after repeal on October 1, 2013. If you think this situation may apply to you, please consult legal counsel for more information.

In sum, California provides some protections for couples who are not married or SRDP to each other. However, those options typically require attention before closing on real property, specifically with guidance from an attorney who understands the property tax issues. Finally, all co-owners who are not married or SRDP should at least consult legal counsel to discuss whether marriage or SRDP registration, a property co-ownership agreement, transfer of property (such as 1%), or updates to a revocable living trust is warranted.

Don't be caught unaware. The consequences could be dire for you or your co-owners.

Alma Soongi Beck is co-presenting public seminars in March 2016 about these rules and the legal implications. For more information or to schedule a free consultation, please visit LakinSpears.com/attorney-alma-soongi-beck, or contact Jack Seabolt, 650-289-6429, jseabolt@lakinspears.com.