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How to permanently reduce your property taxes

By Bernard J. Vogel III

Commercial and residential property owners can take advantage of the current decline in real estate valuations to reduce property taxes and realize substantial long-term savings. Recently reduced assessments may have shown lower tax bills, but this is a temporary reduction. Property taxes will jump back up as soon as the real estate market rebounds. The only way property owners can make this lower assessment permanently is by triggering a change of ownership transaction.

Proposition 13 was an amendment to the California Constitution that restricts both the tax rate and the rate of increase allowed in assessing real property. Except for change in ownership or new construction, the increase in the assessed value of a property is limited to no more than 2 percent per year.

Historically, long time property owners benefit from the capped Proposition 13 assessments. Recently, however, the difference between the market value and assessed value of a property in Santa Clara County has narrowed significantly, and many taxpayers are underwater. According to the newly released Santa Clara County Assessor's report, about 25 percent of all single-family homes and 49 percent of all condominiums are valued below their purchase price.

Proposition 8, a lesser known amendment to the California Constitution, requires a temporary reduction in the assessed value when there is a decline in market value below the property's "factored base year value." If property market values decline below the Proposition 13 factored base year value, country assessors are required to notify property owners that the taxable value of the property has been reduced, and reappraise accordingly with a Proposition 8 notice.

However, this Proposition 8 relief is temporary; the assessed value can skyrocket back up when the Silicon Valley real estate market recovers.

Take for instance, a commercial property owner who purchased an office or commercial building in 2001 for $10 million. The property appreciates, doubling in value during the next six years, and was worth $20 million in 2007. Thanks to Proposition 13, the 2007 property's taxable value was capped at approximately $11,260,000 and the property tax bill was $122,700.

When the real estate market plummeted in 2008, the property valuation dropped to $6 million, which was 40 percent less than the original purchase price. At that time by reason of Proposition 8, the county reassessed the property and the tax bill was cut in half to $65,400.

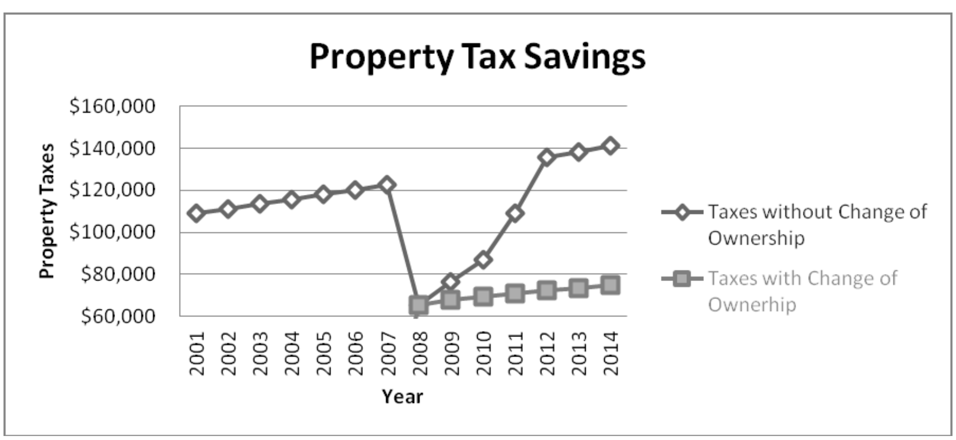
Assume that the real estate market rebounds in 2013; the property appreciates and is now worth $16 million. The property taxes for 2013 will immediately jump back up to $138,000. The Proposition 8 tax relief was short-term because the reduction does not alter the all-important base year used under Proposition 13. Only a change of ownership transaction, such as sale of the property, will result in a new base year.

However, there are ways to cause a change in ownership without an outright sale of the property while retaining control of the property when the fair market value is below the current adjusted base year value. By transferring the property in a non-exempt transaction, such as to a family limited liability company or partnership, or a defective transfer, the owners can lock in the lower Proposition 13 base year value without selling the property; thereby permanently reducing future property taxes.

In the example above, the commercial property owner was able to reset the Proposition 13 base year to 2008 and base year valuation at $6 million. By locking in a new base year, this property owner realized a potential savings of over $500,000 in property taxes over the next decade.

This complicated transaction requires expertise in seven different areas of tax law, and there can be significant tax ramifications. If done improperly, any change in ownership of real property for tax purposes can have significant adverse income, estate and gift taxes as well as local taxes.

Property owners should only consider a change of ownership transaction if they believe that the real estate market will rebound and appreciate, and plan to keep the property for at least several years.



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