GREG BROEGE AND ANDREW DICK

Third-party Trust Equalization Financing for Property Tax Perservation

FOR THE GIFT THAT WILL KEEP ON GIVING, there is nothing like trust-settlement property tax savings. Every trust beneficiary should be so lucky as to obtain property with their parents' or grandparents' low property tax basis, also known as the factored base year value. Luck, however, has nothing to do with it, especially when equalization issues are involved and only one of the beneficiaries wants the decedent's primary residential property. Proper planning will achieve this reassessment exclusion and knowing the law and how to proceed within the law is paramount.

Real property often comprises the largest portion of a decedent's estate. The method and timing of transfer of these real property holdings affect whether the asset will be probated and can determine the transfer taxes and property taxes.[1] Transfer taxes will most often be a single-payment event, while a change in property taxes could have permanent and significant financial impact on the heirs unless properly planned for and addressed at transfer.

Property taxes are based on the assessed value of the property, which is often a trended base year value that is significantly below the fair market value of the property. Upon the death of a property owner, the property may be reassessed at its current fair market value (date-of-death value), resulting in what could be a significant tax increase for properties that have benefitted from significant value appreciation over the years and have had annual tax rate increases limited by the California Constitution.

Reassessments of property values and taxes affect all but very specific transfers of real property. Transfers that are generally not reassessable include interspousal and registered domestic partner transfers, proportional transfers, certain cotenant transfers upon death, and certain creations of joint tenancy transfers. Also exempt from reassessments are parent-child transfers and some grandparent-grandchild transfers. For these there are conditions and procedures that must be followed to ensure compliance. As it relates to trusts, most beneficiaries would appreciate keeping their parents' or grandparents' property tax adjusted basis by avoiding reassessment through parent-child or grandparent-child constitutional exclusions.[2] Trustees and their attorneys must understand the documents, equalization funding options, and the timing involved to obtain these tax benefits.

When the value of the assets being distributed must be adjusted per a non-pro rata distribution, a third-party trustee loan is a common strategy. These loans are short-term (usually less than 12 months), secured by the decedent's primary residential property, and taken out by the trustee with an entity such as a bank or a private money lender. A loan to the trust from the beneficiary's obtaining the property or a direct assignment of beneficial interest in the property (a "sibling-to-sibling" transfer) may negate all or part of the property tax exclusion.

Two trustee loan tips should be remembered. First, bank financing is most economical and best suited for consumer loan use purposes. Deposits and insurance by the Federal Deposit Insurance Corporation are available with this form of financing, which may be important to some trustees but is not available through other lenders. Banks may not lend to trusts without a personal guarantee by the trustee, and banks will often require the property to have a cash flow if it will be converted into an investment property. Second, private money loans (also known as "hard money") fill the void when banks are unwilling or unable to perform in a timely manner, when the property will be used for an ultimate "business purpose" (i.e., rental) or when less documentation than that required by commercial banking institutions is desired by the trustee, including, but not limited to, tax returns, banking information, or personal financial statements as private money loans are primarily interested in the protective equity in the property and in a clearly defined exit strategy by the borrower. Private money financing will almost always carry higher origination fees, higher interest rates, and shorter loan terms than bank financing for these trust loans.

RICHARD EWING

Either source of third-party loans will facilitate trust equalization while preserving the reassessment exclusion above the

Greg Broege is a partner in the Glendale, California, law firm of Ajalat, Polley, Ayoob & Matarese where he focuses on state and local tax matters. Andrew Dick is president of Showcase Investments, a direct private lender, in La Cañada Flintridge, California.

Proposition 13 values.

Proposition 13 was passed on June 6, 1978, to amend the California Constitution. The initiative adjusted real property values to their March 1, 1975, fair market values, capped the ad valorem tax rate at 1 percent, and imposed a no greater than 2 percent annual adjustment to this assessment so long as there is no change in ownership or new construction as defined in the California Revenue and Taxation Code.[3] As most California real estate values have risen far more rapidly than 2 percent annually, property owners looked for a way to pass this factored base year value benefit on to their heirs, resulting in Propositions 58 (parent-child exclusion) and 193 (grandparent-grandchild exclusion).[4]

Probate Code Section 16246 states that the trustee may "effect distribution of property and money in divided or undivided interests and to adjust resulting differences in valuation. A distribution in kind may be made pro rata or non-pro rata."

When a trustee's statutory authority to make non-pro rata distributions is not limited in a share-and-share-alike distribution, the trustee may allocate specific assets to individual beneficiaries, the value of which does not exceed each beneficiary's equal percentage interest in the trust property. Unless prohibited by the trust, a trustee may affect a non-pro rata distribution by encumbering the property him or herself, in the capacity of trustee, with a third-party loan prior to distributing the property to one of the beneficiaries. Funded through the trust bank account, the loan proceeds would then be transferred to the other beneficiaries to equalize the value of the distribution to all beneficiaries.

Once the loan (deed of trust) has been closed and recorded, the property will be distributed via a deed. At the same time, the Preliminary Change of Ownership Report (PCOR) may be filed with the deed. A PCOR is a document filed with the county recorder concurrent with the recordation of any document effecting the change in ownership.[5] Additionally, a claim for reassessment exclusion is filed (either the Proposition 58 parent-child exclusion or the Proposition 193 grandparent-grandchild form) with the county assessor's office.

The parent-child exclusion is not automatically granted. Trustees or their attorneys must file an exclusion form with the county assessor in which the property is located. (Consult the local assessor's Web site for the preferred form). The parent-child exclusion must be filed within three years of the transfer date to have full retroactive effect.[6] However, even if filed within three years, the form generally must be filed before the property is transferred to a third party. Forms filed outside of the three-year period but before a transfer to a third party, will have prospective effect only.[7] If the form is filed within six months of a notice of supplemental or escape assessment, though, the parent-child exclusion will have full retroactive effect no matter how long after the transfer date.[8]

For trustees who wish to obtain third-party financing for equalization and the preservation of the Proposition 58 reassessment exclusion, all California lending companies, including commercial banks and private money lenders, must comply with two Dodd-Frank requirements: The Truth in Lending Act (TILA), which is implemented by the Federal Reserve Board's Regulation Z,[9] and the Real Estate Settlement Procedures Act (RESPA), implemented by the Federal Reserve's Regulation X.[10]

Dodd-Frank Act

The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act amended 18 separate laws to regulate all forms of consumer credit transactions while creating the Consumer Finance Protection Bureau, which has rule-making authority.[11] For consumer loan lenders, this includes extensive RESPA amendments, TILA compliance, and disclosure requirements as well as loan servicing prohibitions and a three-day right to rescind.[12] Through its regulatory compliance requirements,[13] Dodd-Frank affects a lender's consumer mortgage origination by imposing mandates on annual percentage interest rates, disclosures, and loan appraisal requirements. These consumer protections have no direct impact on an heir's ability to qualify for property tax reassessment exclusions. However, due to the overall interest rate suppression, additional documentation, and reporting requirements of Dodd-Frank and TILA, many private money lenders abandoned consumer loans in favor of transactions that fall under one of the available exemptions to the regulations. These exemptions to TILA include bridge loans (loans for less than 12 months when a borrower is between property ownerships), entity loans (loans to non-natural persons), and loans for stated "business purpose" uses.[14]

Banking institutions are the go-to source for consumer loans. These are financings for which the ultimate use of the loan proceeds will be a "consumer," meaning for personal, family, or household use.[15] Banks also continue to be the primary source for business property financings. If a bank is unwilling or unable to qualify a borrower, or the borrower requires funding in less time than the bank can process the loan, borrowers can look for funds through private money lenders. These lenders almost exclusively rely on one of the three exemptions (bridge loan, entity loan, business purpose) mentioned above to qualify the borrower and underwrite the loan.

Individual trusts are not considered business entities, so the use of funds becomes the paramount qualifier for the private money lender, regardless of the secured real property. For example, a loan secured by a commercial property (seemingly a non-consumer loan) with the loan proceeds used to fund the borrower's home kitchen remodel is a consumer use and therefore a consumer loan. If the funds will be used as a "bridge" between ownership of one property and the eventual ownership of a trust property, and the loan will be written for 12 months or less, the private money lender may be able to lend under the bridge loan exemption.

For non-consumer use that does not qualify under the bridge loan exemption, the parties are left with the business purpose loan exemption. This exemption is for "business, commercial or agricultural purpose."[16] To make a lending determination, private money lenders use a published list of "Five Factors,"[17] which includes a handwritten borrower statement of primary loan purpose. "Primary" means 51 percent or more of the funded loan proceeds must be used for such purposes as investment property purchase, investment property rehabilitation, business operations, and more. Most private lenders prefer a borrower statement that 100 percent of the loan proceeds will be allocated to these activities, providing them with some underwriting protection.

Investment properties are often defined as non-owner-occupied dwellings when determining the use of the loan funds, and if the private money lender is informed that the trustee or one of the beneficiaries will be occupying the inherited property for more than 14 days in the coming year (e.g., as a primary residence or a vacation home), the use is now for consumer purposes, which may disqualify the loan for the private money lender but not necessarily for a commercial bank. However, if the loan will be used to fund the purchase of a triplex or larger multifamily property, the trustee or one of the beneficiaries may occupy one of the units and the loan will still qualify as a business purpose loan.

Case Study

Assume that the parents of Ben, Brian, and Betsy transferred their community property primary residence to a revocable trust. The parents (trustors) passed away

but, because of the trust, which is now irrevocable, probate will not be required to change title to the assets. The parents had lived in the home since 1976 when they purchased it for $150,000. When the parents died in 2014, the family home was valued at $1.8 million, was unencumbered, and was the only asset in the trust. Brian and Betsy have no desire to keep the house, but Ben would like to convert it into a rental property (business purpose) and maintain the low property tax basis.

To help Ben qualify for the Proposition 58 tax reassessment exclusion (parent-to-child), Betsy, as trustee, turns first to conventional (bank) lenders for a loan, whether directly or through a mortgage broker. Banks that make residential loans to trusts require copies of the trust and death certificate, a 1003 loan application, a bank-assigned independent appraisal of the property, a credit report of the trustee, and clear title. Conventional banks may also require documentation from the trustee, including a personal guarantee, prepayment penalties for up to six months and, often, a personal financial statement. If the heir to the property will use it as a primary residence, the heir will need to personally qualify for the bank loan. If the property will be used for investment, the bank will require that the property is cash-flowing before they will approve funding, which can be tricky for vacant homes.

A true benefit of the bank loan over private money loans is apparent when the ultimate purpose of the loan will be for consumer use. In other words, if the beneficiary inheriting the property will be converting it to his or her primary residence without owning an existing residence (which may qualify the loan as a bridge transaction), this is considered a consumer transaction, and this form of use is most often best suited for conventional bank loans because of their lower fees and interest rates. However, it is not a requirement of Proposition 58 or 193 that the property be the new principal residence of the person acquiring the property. The potential drawback for bank financing can be the funding timeframe, which can be up to 60 days from submittal to funding.

Another source for trustee loan funding is from private (or "hard") money sources. These lenders are most often concerned with the equity in the property and the use of the funds, especially with the trustee's representation of the beneficiary's intended bridge loan or business-purpose use, such as making it a rental property once the trust settles. Private money lenders typically require similar loan applications, trust documentation, and property appraisal valuations but can fund in as few as 10 business days. As these loans are primarily secured by equity in the property—a key distinguishing factor between bank and private money financings—they often have slightly higher loan fees and will carry a higher rate of interest but do not require the same prepayment penalty duration (if any), the same degree of documentation or a personal financial statement as required by banks. Most trustee loans are written for up to three-year durations but are bank-refinanced by the beneficiary into permanent loans upon settlement of the trust.

Private money lenders also do not penalize the borrower if, after the loan funds, the intended use of the property changes. Borrowers and their intended uses of the loan are qualified during the origination period. The loan is not due upon this change-in-circumstances event, and a change to the use (rental to residence) of the property by the beneficiary will likely not affect the tax assessment exclusion.

Either source of financing will require some underwriting of the ultimate beneficiary, as this will be the person responsible for making the payments upon settlement of the trust and will need to demonstrate some level of creditworthiness to refinance the trustee loan, also known as the "exit strategy."

Scenario One. Betsy does not have trust authority to make non-pro rata distributions. The parents directed that the trust property be equally distributed to each child, so the trustee conveys the residence to all three children as tenants-in-common. Then, in a good-faith attempt to help brother Ben, Brian and Betsy transfer their interests to him. How is this perceived by the assessor? The initial transfer to all three children qualifies for the parent-child exclusion. However, when two of the children make a sibling-to-sibling transfer, there will be a two-thirds reassessment of the property, while Ben's remaining share will not be reassessed.

Scenario Two. Betsy is now authorized by the trust to make non-pro rata distributions, distributed on a share-and-share-alike basis. Betsy distributes the house to Ben who then obtains a new bank line of credit secured by the property and uses these funds to pay Betsy and Brian their two-thirds of the value ($600,000 x 2 = $1.2 million). Ben's thinking was that the line of credit was more convenient than if the trustee (Betsy) had taken out the initial equalization loan and Ben had to take out a subsequent exit-strategy loan. Also, the bank loan interest was lower than a private money lender's rates, so it made sense. However, because this will be construed as a sibling transfer, two-thirds of the property will be ineligible for the reassessment exclusion, while the remaining one-third would receive the Proposition 13-factored base year value. Ben's decision would result in paying significantly more annual property taxes.

Scenario Three. As with Scenario Two, Betsy is authorized by the trust to make non-pro rata distributions on a share-and-share-alike basis. She decides to distribute the entire residence to Ben, and borrows $1.2 million from a third-party lender, secured by the free-and-clear residence. The loan has a minimal three-month guaranteed payment provision and no penalties, including any change of use designation after loan funding.

Betsy distributes these funds to Brian and herself at one-third ($600,000) percentages each. If all other requirements are satisfied, Ben will now take title to the property subject to the $1.2 million encumbrance and would be responsible for repaying the loan. This encumbrance would equalize the non-pro rata distributions. Ben would receive a full parent-child exclusion on the property; therefore, the property would not be reassessed to fair market value.

Private Money Lender or Bank

Banks are widely considered the go-to source for trustee financing if the specific institutions will make trustee loans and if trustees have enough time before funding is required. If a residence will be converted to income property, banks want to see that the property is cash-flowing, which will be hard to do if the property is not yet income-producing. Because a private money lender is primarily interested in the equity, cash flow is a less important consideration than it is for a bank. Also, if the property will become a primary residence of a beneficiary, banks will need to thoroughly underwrite the loan based on the financial strength of the inheriting beneficiary. Qualification of the heir is also important to private money lenders for exit-strategy purposes, but equity is paramount.

When comparing lending resources, trustees should consider speed of funding, origination costs, and interest costs. Banks may impose either a fixed fee or up to a 1-point origination fee as well as a typically lower interest rate (currently between 4 percent and 6 percent for 30-year terms, depending on occupancy and use of property) but may have a minimum loan term. For a $1.2 million loan at 5 percent amortized over 30 years, a current market loan

fee would be $3,200 and the interest cost for a minimum three-month period would be $19,326 (30-year amortization), for a total bank-loan cost of $22,526 and 45 days to fund. If only a line-of-credit loan option can be offered (such as for income-producing property conversions, where the former primary residence will be converted by the beneficiary to an income property) that are not yet cash-flow positive, costs will be higher.

A private money loan of the same amount at 1.75 points origination, 9.25 percent interest, and a one-month minimum loan term would cost $30,200 ($21,000 + $9,250 interest only) but could fund in as few as 10 business days. Although costs for the private money loan are higher than the bank in this example, the bank may not be able to fund the loan if the beneficiary does not qualify, if the trustee is unwilling to sign a personal guarantee, or if the property is not yet cash-flow positive. Equity in the property is paramount for the lending decision of a private money lender. Borrowers should consult with a tax attorney, trust attorney, or mortgage broker to identify a private money lender who understands trust lending and who offers competitive fees and rates along with short (one-to-two months) minimum required interest obligations on the loans.

Regardless of loan type, great care should be exercised by the trustee and his or her legal advisor when applying for trustee loans to determine whether bank financing will be used or if private money loans may be an option. ■

---

[1] The transfer tax is an excise tax for the privilege of transferring realty. (City of Huntington Beach v. Superior Court 78 Cal. App. 3d 333, 341 (1978)). It is a one-time tax paid upon the transfer of realty. Property taxes are ad valorem taxes paid yearly and represent a direct tax on property.

[2] This article does not address transfers by will or intestate succession

[3] CAL. CONST. art. XIII A, §1.

[4] Proposition 58, codified as REV. & TAX CODE §63.1, and adopted November 4, 1986, applies to any purchases or transfers between parents and children that occur on or after November 6, 1986. Proposition 193, adopted March 26, 1996, amended Section 63.1 for grandparent-grandchild provisions.

[5] REV. & TAX CODE §480.3(a).

[6] REV. & TAX CODE §63.1(e)(1)(B).

[7] REV. & TAX CODE §63.1(e)(2).

[8] REV. & TAX CODE §63.1(e)(1)(C).

[9] 12 C.F.R. Part 1026.

[10] 12 U.S.C. §2601.

[11] 15 U.S.C. §1601 *et. seq.*

[12] 12 C.F.R. §1026.23(b)(1),1026.23(c).

[13] 12 C.F.R. §1026 *et. seq.*

[14] 12 C.F.R. §1026.3(a)(1) and (2).

[15] 15 U.S.C. §1602(i).

[16] 12 C.F.R. §1026.3(1)(a)(1).

[17] 12 C.F.R. §1026(a)(3).