“Protect Homeowners and Close Corporate Tax Loopholes Act”

Board Action: OPPOSE

Rationale:

The current tax system allows for California property owners to project their property taxes with a degree of certainty. Without the current property tax system, such property taxes would have increased significantly during growth and dropped during declines in the real estate market.

Proponents of the proposed split-roll amendment claim that a loophole, allowing corporations to avoid reassessment, has shifted the tax burden to homeowners. Their intent, is to combat the shift in tax burden by doubling the homeowner’s property tax exemption and reassessing commercial property back to market rate every three years. With assessed residential and non-residential property values increasing at nearly an identical rate since the passage of Proposition 13, there is no reason to conclude that a significant shift has or is taking place.

Taxpayers who rent or own commercial property would be vulnerable under a split-roll tax system that regularly assesses the property because a property’s market value may fluctuate significantly over a short period of time. For some businesses, the increased financial burden may cause them to close their doors, decreasing the productivity of our local and state economy and ultimately could result in higher rental rates, fewer jobs available and increased consumer prices.

Background:

California’s system of property taxation under Section 2 of Article XIII A in the California State Constitution (Proposition 13) values residential and commercial property at its full cash value, with annual increases limited to the inflation rate, as measured by the state’s Consumer Price Index (CPI), or two percent, whichever is less, until the property changes ownership. At the time of ownership change, the value of the property for property tax purposes is reassessed based on current market value.

Prior to Proposition 13’s passage, the property tax was an ad valorem system. Counties prior to passage of Proposition 13 assessed properties at wide ranging values. In addition, property tax values in some occasions varied significantly in a short time period (i.e. few years).

1 The county assessors 1975-96 valuation, or if property obtained thereafter the valuation’s base year is its year of acquired ownership.
Since the passage of Proposition 13 in 1978, there has been concern that commercial property changes ownership less frequently than residential property, and because of that, that there is now an unintended shift of the tax burden to residential taxpayers. To deal with this unintended shift of tax burden, it has been proposed to either alter the definition of “change of ownership” and, in doing so, the interpretation of Proposition 13, or reassess commercial properties at predetermined intervals. Both of these approaches have been referred to as a “split-roll” property tax system, however they significantly differ.

There have been several proposals to amend the constitution’s acquisition value system of property taxation into a split-roll process that periodically appraises commercial and industrial properties at their current market values. Non-residential property in either split-roll property tax system is estimated to bring in a significant amount of tax revenue.

Proposal:

On November 21, 2011, an initiative was filed with the Office of the Attorney General entitled, “Protect Homeowners and Close Corporate Tax Loopholes Act.” The measure is intended to begin reassessing non-residential, non-agricultural real property to market value at least once every three years beginning immediately following the lien date for fiscal year 2015. In addition, the Homeowner Property Tax exemption would double from $7,000 to $14,000, and would exempt the first $1,000,000 of tangible personal property from taxation beginning in fiscal year 2016.

Under the “Findings and Declarations” section of the measure it states:

“California’s property tax system contains a gigantic loophole that allows corporations and commercial property owners to avoid paying their fair share. That loophole often allows businesses to change ownership without being reassessed, which homeowners cannot do. As a result, the burden of paying for things like police and fire services now falls more heavily on homeowners.”

The initiative is still in the process of collecting signatures and has until June 21, 2012 to submit 807,615 qualified signatures.

Fiscal Impact:

Fiscal Analysis
Proposition 13 limits the amount of tax revenue to the average inflation rate. Property tax revenue has the potential to increase only when there is considerable development of new real-estate, or if property is resold in an appreciating market. By reassessing values on a regular basis, property tax revenues would increase. This would be partially offset by the decrease in property values that would come from increased cost of owning commercial property.
The “Protect Homeowners and Close Corporate Tax Loopholes Act” would also make two other significant changes to the collection of property taxes. It would double the homeowners' property tax exemption from $7,000 to $14,000, and would exempt the first $1,000,000 of tangible personal property from taxation. Both would decrease property tax revenues.

Since a large portion of property tax revenue goes towards funding for education in the state of California, any net increase in property taxes would help raise the funds allocated to public state schools.

The proposed split-roll tax would affect the ability to perform its assessment duties. The state government must examine how much more the process of reassessment of all non-residential properties every three years would cost and how long it would take. Otherwise, the State needs to set guidelines of what is considered as “non-residential property” and in particular properties that are used for multi-purposes. Therefore, there is an issue of deciding exactly what category certain properties fall under. For example, there is a complication of what category “work-live property” would be classified as. The initiative defines nonresidential real property as “any real property other than a single-family or multifamily unit that is intended to be used primarily as a permanent residence and is used primarily as a permanent residence or that is zoned as a residence, and the land on which that unit is constructed, or any portion of the property used as a residence.” This may clarify how a property is to be treated that is living space above a store front, however, for example, the question remains as to how an artist loft would be categorized. The question the State would need to answer is under what guidelines such properties would be considered commercial properties. This decision could have a significant impact on which properties is subject to reappraisals and higher taxes.

General Economic Analysis

In economic theory, firms make decisions at the margin. This means that firms compare expected benefit of each additional investment opportunity to each additional expected cost. In the short run, a split-roll property tax system would increase the tax burden on commercial, industrial, and non-owner occupied residential property.

In the long run, this increase would affect property owners in financially significant ways. Increases in property tax will make land and capital more expensive for businesses in California. Additionally, property owners’ financial circumstances will be worse off post property tax increases as it will not be able to offset all of the higher property taxes to renters, consumers and/or employees. If property owners could raise prices without losing business, they would. So, in the long run, if space becomes more expensive because a tax increase is being completely passed on, property owners would see fewer profits. Either some renters would use less space, or some renters would be priced out, or more likely, some combination of both. This would cause property owners, on average, to see less after-tax revenues, and fewer profits. Ultimately, this is the same as sharing in the tax burden.

The adoption of a split-roll property tax would increase the usage cost of land and capital by businesses, therefore, weaken their financial conditions. Businesses seek to minimize their
profits.3 Since firms evaluate the relative burden of state and county taxes when deciding about the business’ location, this is an aspect that may influence business decisions.4 A split-roll property tax would increase a firm’s cost and not increase expected benefits and investment opportunities, keeping all things constant.5 Firms would then have less profits to reinvest, increase operations or take out as profits.

The conditions of markets also determine if investments are to be made. Tax policies adopted by a state alone are not known to typically cause a firm to relocate or locate to an area where the resources are not sufficient (i.e. skilled labor, transport, etc).6 A state’s tax burden on a firm may affect its total costs, therefore, if a company operates in a high tax state then the firm must reduce costs or raise prices to maximize its after tax profits.

The long run impact on jobs, wages and investment in California will be determined by the reaction of firms and owners to the above factors. According to economic theory, if there is an increase in rents, tenants would have less operating income to spend on other goods and services.7 The impact would be felt beyond commercial property owners and its renters. If there was a decrease in the amount of business investment in California, then there would be some combination of increases in unemployment, increases in consumer prices, decreases in wages and decreases in the use of land and capital.

Under the adoption of a split-roll, some businesses would need to offset potential increases in rent or tax liabilities, and if unable to do so, they may potentially go out of business. The adoption of a split-roll regime that separates non-residential properties from Proposition 13’s property taxation fiscal impact is potentially harmful to California’s business and economic climate, which would result in less State tax revenues.

A common discussed fiscal impact of Proposition 13 is that the taxation system it implements shifts a tax burden from commercial to residential properties. Since Proposition 13’s passage, there have been several allegations that such a shift exists. The California Taxpayers Association produced an analysis8 in 2009 using data from the Board of Equalization. It concludes that Proposition 13 has not resulted in a tax burden shift to residential property owners.

The following figure demonstrates that assessed residential and commercial property values increased at similar rates under Proposition 13, maintaining a similar balance. The balance in Fiscal Year 2007 (41.6%) is less than one percent of Assessed Value different than it was in 1982 (40.1%).

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3 Firms seek to maximize profits after taxes and expenses such as wages.
4 A higher property tax may factor firm’s managerial decisions, but it does not limit their decision to locate, expand or downsize operations.
5 If a split-roll property tax was to be introduced and projected to decrease profits then there would be less economic incentive to begin or continue production in California, ceteris paribus.
6 Sometimes location is more important than tax burdens on the investments of a firm.
7 Tenants would incur higher rents paid therefore having less operating income. As a result, ceteris paribus, consumption would decrease and firms who provide goods and services to these renters would in return be negatively affected.
8 [http://www.caltax.org/Proposition13Revisited12-7-09.pdf](http://www.caltax.org/Proposition13Revisited12-7-09.pdf)
Comparing the change in the assessed value of residential and commercial property under Proposition 13 suggests that Proposition 13 has not shifted a substantial tax burden onto homeowners.

As seen in the following table that directly focuses on the share of the property tax burden, the share of the tax burden between homeowners and other Proposition 13 property tax payers has varied by under three percent of total Proposition 13 assessed values since 1982, the period for which all data sources are available and consistent assessment practices were followed.

Data Source: California Taxpayers Association
With no evidence to suggest a substantial shift of tax burden, it would be irresponsible to conclude that a shifting tax burden should be addressed with an amendment to California’s Constitution.

**Proponent Arguments:**

Proponents of a periodically reassessment based split-roll property tax system argue that in order to remove market distortions and tax inequities in California, businesses’ property values should be reassessed on a regular basis. Proponents insist that commercial properties enjoy an unfair subsidy whereas homeowners do not. If Proposition 13 were amended as a split-roll property tax system, then additional tax revenue may be acquired from undervalued commercial and industrial sector landholdings. Therefore, split-roll property tax proponents maintain that homeowners encounter a burden as the property tax has shifted over to residents and local governments. In addition, proponents argue that since the split-roll taxation system is a tax on holdings, the burden cannot be shifted into the market. As a result, the additional revenue gained in a split-roll tax is likely to be borne by the owners of the property.\(^9\) Proponents insist that Proposition 13 creates an inefficient real estate market because there are disincentives to sell property to avoid a higher assessment and that non-residential property owners are able to take advantage of a loophole by effectively changing ownership without being reassessed\(^{10}\). Lastly, proponents argue that the assessments are unequal because it is based on the purchase date; therefore, properties may have different appraisals even if they are in the same community.

**Opponent Arguments:**

Opponents of a split-roll property tax system argue that the state of California’s most reliable tax for the government is under Proposition 13. Opponents maintain that during recessions the property taxes were not as affected as income taxes. Opponents counter argument to the proponent’s argument of a shift in tax burden is that in order to take the burden off homeowners, if there is a raise in commercial property taxes, then there needs to be a property tax cut to homeowners. Opponents insist that what Proposition 13 has currently set in place has provided stability predictability for property owners. Opponents of a split-roll property taxation system maintain that an amendment of a split-roll property tax would create unintended consequences that would affect not only Californian businesses and consumers but the state’s overall economic climate.

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\(^9\) Proponents maintain that the profile of commercial real estate owners are higher income taxpayers

\(^{10}\) This is under the assumption that there is appreciation from the base year.