March 2, 2005

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the constitutional and statutory initiative entitled "The Tax Reduction and Taxpayer Equity Act of 2005" relating to the local property tax and various state taxes (File No. SA2005RF0047).

Background on State and Local Taxes

Property Taxes. Under the California Constitution and state statutes, real and personal property—commercial and residential—is subject to a general-purpose *ad valorem* property tax rate of 1 percent. The policies for determining the value of properties, however, vary. State assessed and personal properties are taxed at their full market values. Locally assessed real property, in contrast, is taxed at its "full cash value." The Constitution generally defines full cash value as the value of the property when it was acquired by its current owner (usually, its acquisition price) or the property's 1975 value. The Constitution specifies that each property's full cash value may be increased annually for inflation, at a rate not to exceed 2 percent. The Constitution also provides for a homeowner's property tax exemption on the first $7,000 of assessed value.

Local property tax revenues are distributed to school districts, community colleges, cities, counties, and special districts based on statutory provisions. Local property tax revenues allocated to school districts and community colleges count toward the Proposition 98 minimum funding guarantee. Increases in local property tax revenues generally reduce state obligations to meet the Proposition 98 minimum guarantee.

State Income Taxes. The state levies a personal income tax (PIT) on the income individuals and noncorporation businesses in California. The rates of the tax range from 1 percent to 9.3 percent depending upon the taxpayer's income (with an extra 1 percent levied on taxpayers' incomes greater than $1 million). The state also levies a corporation tax (CT) on net earnings of businesses operating within California. For California corporations, net income is taxed at the rate of 8.84 percent. All corporations are allowed certain deductions from income and credits against the tax. In 2004-05, the PIT is expected to raise about $41 billion in revenues and the CT about $9 billion.

Insurance Gross Premiums Tax. In lieu of paying the CT, insurance companies operating in California pay a tax equal to 2.35 percent of gross premiums collected.

Provisions of the Initiative

Property Taxes

Reassessment and Tax Rate. This measure makes changes to (1) the rates imposed on state and locally assessed property and (2) the annual inflation adjustment to a property's full cash value. Specifically, the measure authorizes each county board of supervisors to set the property tax rate for commercial properties at 2 percent to 3 percent of its full cash value. The rate that a county board of supervisors sets for commercial properties also would apply to a portion of the value for some residential properties. (The measure specifies that the definition of residential property would be established by the Legislature.) Specifically, any full cash value for a residential property in excess of $2 million (or "high value" residential property) would be taxed at the same rate set for commercial properties. All other residential property would continue to be taxed at a rate of 1 percent. The ratio of the tax rate for commercial and high value residential property to the tax rate on regular residential property could not be less than 3 to 1.

The measure also makes a significant change to the provisions of the Constitution regarding annual inflation adjustments to a property's full cash value. Specifically, the measure appears to eliminate for commercial property and high value residential property the annual inflation adjustments to a property's full cash value.

Homeowners' Property Tax Exemption. The measure increases the existing homeowners' property tax exemption from $7,000 to a minimum of $70,000. In addition to this standard exemption, an additional $10,000 of value would be exempted for each special qualification (such as age or disability) of the homeowner. For example, homeowners over the age of 61 would be eligible for an additional exemption of $10,000, for a total exemption of $80,000. The maximum property tax exemption would be $110,000.

Personal Property Taxation. The state could adjust the rate of tax on personal property, as long as it did not exceed the rate of tax on commercial property in the same taxing jurisdiction.

Income Taxes

The measure requires the Legislature to annually adjust the CT rate such that the tax burden on corporations is equal to the tax burden on entities paying the PIT. This could be accomplished by increasing the CT rate, decreasing the PIT rate, or through some combination of the two actions such that the revenues raised by each of the two taxes was equal in each fiscal year. The measure allows the Legislature to adjust the CT rate—and reduce credits or deductions—with a majority vote of both houses.

Insurance Gross Premiums Tax

The measure increases the premiums tax rate from 2.35 percent to 7 percent beginning in 2006. The state could reduce this rate—but to no less than 3 percent. The measure also requires ocean marine insurers to apportion their gross premium revenues based on the proportion their California business represents of the total.

Fiscal Effects of the Initiative

Property Taxes

The effect of the measure on local property taxes would depend on the future tax rate decisions made by the county boards of supervisors and on future state actions regarding the definition of residential property and the assessment of certain property. Under the assumptions that commercial and high value residential properties are assessed at full cash value and that residential property is broadly defined, the measure would result in the following increases in property tax revenues:

- At the minimum rates of 2 percent on commercial and high value residential property and at one-third that rate (or 0.67 percent) on residential property, local property taxes would rise by about $4 billion annually.
- At the maximum rates of 3 percent for commercial and high value residential and at one-third that rate (1 percent) for residential property, the corresponding increase in local property taxes would be upwards of $20 billion annually.

Of these higher property tax revenues, about 60 percent would be available to noneducation local governments for general purposes. The remaining revenues would go to schools, which has the effect of reducing state school spending obligations.

State Revenues and Spending

There would be numerous major impacts on state revenues and spending. These impacts would vary substantially depending upon legislative actions regarding tax rates and overall revenue levels and county boards of supervisors actions regarding property tax rates.

Revenues. The state would experience the following changes in revenues:

- The most significant change would be from the measure's requirement that the PIT and CT raise an equivalent amount of revenue. To meet this requirement, the state would likely have to increase CT revenues by billions of dollars and decrease PIT revenues by an offsetting amount. For example, reducing the PIT burden by roughly 30 percent and increasing the CT by about 300 percent would result in: (1) each raising about the same amount of revenue and (2) both taxes together raising about the same total revenue as would be raised under existing rates.
- There would be an increase in insurance tax revenues of from the mid-hundreds of millions of dollars to more than $4 billion annually, depending upon the rate set by the Legislature.
- The CT revenues would decline due to greater deductions relating to increased local property taxes. The reduction would be in the low hundreds of millions of dollars to approximately $1.5 billion annually, depending upon the amounts collected in local property taxes.

Spending. The state would experience the following changes in spending:

- Reduced spending on K-14 education as a result of increased local property tax revenues. These spending reductions would range from under $1 billion to about $8 billion annually, depending upon changes in local property tax rates.
- Increased spending of around $4.5 billion as a result of mandated increases in the homeowner's exemption.

The net impact on state finances is unknown, as it would depend on future choices of the Legislature. It could adjust various state tax rates, however, to minimize any net impact on state finances.

Tax Incidence

There would be significant differences in the types of taxpayers experiencing increased tax burdens and those benefiting from reduced taxes. State and local taxes would increase on businesses paying the property tax, insurance tax, and the CT. Taxes could decrease on households paying the property tax and the PIT.

Indirect Impacts of the Measure

The owners of nonresidential real property would face increased costs due to higher property taxes imposed by the measure and potential increases in state level taxes, which could reduce after-tax incomes. Any decline in after-tax business income could result in state and local revenue reductions to the extent it reduces business activity, due to such factors as lower investment, fewer business expansions, and reduced operations. These reductions would be partially offset by the effects of the increased homeowner's exemption as well as any reductions in the PIT, both of which would likely increase consumer demand. The net effect of these factors on revenues is unknown.

Summary of Fiscal Effects

The measure would have the following major fiscal effects:

- Increased annual local property tax revenues, ranging from the low billions of dollars to in excess of $20 billion.
- Unknown net impact on state finances from major changes in both revenues and expenditures. Impact would depend on future legislative actions.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance