December 16, 2009

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the constitutional and statutory initiative (A.G. File No. 09-0077), which affects assessments of nonresidential real property for local property taxes.

BACKGROUND

Local Property Tax

The State Constitution establishes a 1 percent maximum base property tax rate on real and personal property. Counties collect these tax revenues and allocate them to local governments (cities, counties, special districts, redevelopment agencies, schools, and community colleges) according to law.

Real property includes land, buildings, and other things affixed to the land. Personal property includes boats, airplanes, business fixtures, and other property not affixed to real property.

Most real property is assessed for tax purposes based on its acquisition cost, plus an adjustment of up to a 2 percent increase each year to account for inflation. For personal property (such as business equipment), assessed value is based on the current market value of the property irrespective of its acquisition date.

State and Local Tax Exemptions, Deductions, and Credits

State law creates general exemptions, deductions, and credits related to property taxes that reduce the amount of taxes owed, including the following:

Homeowner's Property Tax Exemption. The Constitution grants a $7,000 property tax exemption on the assessed value of owner-occupied dwellings. The state is required to reimburse local governments for the resulting reduction in local property tax revenues. This exemption reduces the typical homeowner's taxes by about $75 annually. The state provided about $450 million from the state's General Fund to reimburse local governments for this exemption in 2008-09.

Property Tax Deduction. Businesses may deduct payment of local property taxes as a business expense in their computation of taxable income under the state's corporate tax (CT) and personal income tax (PIT). The Franchise Tax Board estimates business property tax deductions to be around $500 million in 2008-09.

Renter's Tax Credit. Low-income renters may claim a non-refundable credit that reduces their state PIT liability. In 2008-09, the credit provided up to $120 in tax relief per household at a total cost to the state of about $100 million.

Proposition 98

Adopted by the voters in 1988 and amended in 1990, Proposition 98 establishes a set of formulas that determines each year the minimum required funding level for K-12 schools and the community colleges. In 2008-09, K-12 schools and community colleges received a total of $49 billion in Proposition 98 funding. This funding level is met using state General Fund dollars and local property tax revenues.

PROPOSAL

This measure amends the Constitution to (1) alter the assessment practices for certain commercial property and (2) deposits most of the new tax revenues into the General Fund. We discuss these changes below.

Tax Changes

Assessment Changes. The measure requires counties to assess nonresidential, nonagricultural real property based on actual market value. This would raise property taxes for a significant proportion of commercial property owners. The new assessment practices are phased in over a three-year period beginning in 2012-13. The measure also requires counties to reassess this property at least once every three years. Most residential property (single-family homes or multifamily dwellings) and agricultural property are not affected by the measure.

Tax Exemptions. The measure also makes several other changes to current law regarding property taxes. Specifically, it (1) exempts from taxation the first $1 million of value of business personal property and (2) doubles the homeowner's property tax exemption (to $14,000) and the renter's tax credit (to a maximum of $240). The measure requires the state to reimburse local governments for lost revenues associated with the personal property and homeowner's exemptions.

Distribution of New Property Tax Revenue

From the additional tax revenues resulting from the measure, counties would retain a "reasonable" amount for the increased costs of reassessing nonresidential real property every three years based on market value. Of the remaining funds, 90 percent would be deposited in the state's General Fund, and 10 percent would be distributed to local entities within each county.

Implementation Period

As noted above, the new assessment policy affects tax liabilities beginning in 2012-13. Counties are directed to implement the new assessments over three years, beginning with those properties that have not changed ownership for the longest period of time. Over the same period, exemptions also are phased in, with the homeowner's exemption and renter's credit increases to start in 2013-14 and the personal property exemption to start in 2014-15.

FISCAL EFFECTS

Effects on Tax Revenues

Increased Property Taxes. In 2008-09, California property owners paid approximately $10 billion in property taxes for nonresidential real property as defined in the measure. Based on data from the Board of Equalization, we estimate that reassessing this property at fair market value would generate additional property tax revenues of around $4.5 billion annually. This estimate is sensitive to real estate market conditions and subject to significant variability.

County Administration Costs. From the higher tax revenues generated by the new assessment policy, counties would deduct a "reasonable" amount for the higher costs of assessing the specified commercial properties based on market value. We estimate these costs to be in the tens of millions of dollars annually.

State and Local Revenue Increase. Based on the division of revenues between the state and local agencies required by the measure, we estimate the measure would increase state General Fund resources by about $4 billion annually. (This represents about a 4 percent increase in General fund revenues.) Local governments would receive about $400 million each year in new revenues. About 60 percent of these funds would be allocated to cities, counties, and special districts. The other 40 percent would be distributed to K-12 and community college districts. (This increase is equivalent to about a 1 percent increase in existing local revenues.) The measure phases in the higher assessments over three years, so the increase in state and local revenues would be lower in the first two years.

Indirect Effects on Revenues. Owners of nonresidential real property would face increased costs due to the higher property tax rates imposed by the measure, which would reduce after-tax incomes. The reduction in after-tax incomes could result in state and local revenue reductions to the extent it reduces business activity, due to such factors as less investment, fewer business expansions, and reduced operations. Some businesses would act to avoid absorbing these costs, such as by "passing them along" to consumers through higher product prices or to employees by cutting back on hours or wages compared to what they otherwise would be. These actions too, however, could reduce overall economic activity and thus revenues. Conversely, the effects of spending increases discussed below would have positive indirect effects on state revenues. The net effect of these factors on revenues is unknown.

Other Fiscal Impacts

Local Property Tax Losses. The measure requires the State Controller to reimburse local governments for lost revenues due to the partial exemption for business personal property and the increased homeowner's tax exemption. We estimate these General Fund costs at about $1 billion annually. (Because the measure requires the state to reimburse local governments for these losses, the fiscal effect of the exemptions is reflected as an expenditure rather than as lower revenues.)

General Fund Tax Effects. We estimate the measure would result in a General Fund revenue loss of about $300 million due to the higher renter's tax credit and the loss of PIT and CT revenues caused by individuals and businesses deducting the higher business property tax payments from income taxes. Personal and corporate income tax losses could vary significantly over time consistent with the fluctuations in assessed values of commercial properties.

Increased Spending for K-14 Education. The additional General Fund revenues generated by the new assessment policy would result in a larger Proposition 98 funding requirement. We estimate that, under most circumstances, the new revenues would increase the Proposition 98 funding requirement by about $2 billion annually when the measure is fully implemented. The General Fund impact of the higher minimum guarantee also would be offset to a limited extent—up to several hundred million dollars annually—by additional local property taxes that would be allocated to local education agencies under the measure.

The increase in Proposition 98 spending requirements could vary significantly over time if the increases in General Fund revenues from the measure fluctuate from year to year due to changing assessed values of commercial properties. In addition, the three-year phase in of new assessments under the measure would result in somewhat lower Proposition 98 increases during the first two years of implementation.

Increased State Administrative Costs. The state would incur additional costs associated with reimbursing counties for lost revenues, allocating funds to cities, counties, and implementing other provisions of the measure. We estimate these responsibilities would result in minor costs.

Other State Spending. After accounting for the cost of the higher property tax exemptions, offsetting revenue losses, and state administrative expenses, the state's General Fund would experience a net increase in resources of about $3 billion annually. Of this amount, the state would be required to dedicate $2 billion to K-14 education. The remaining $1 billion could be spent by the Legislature on any purpose. As the residual of all the other requirements of the measure, however, this amount could vary considerably over time.

Summary of Fiscal Effects

The measure would have the following major fiscal effects:

- Additional net state General Fund revenues of about $3 billion annually and additional local government revenues of about $400 million annually when the measure is fully implemented in 2014-15.
- Increased state funding for K-12 schools and community colleges of about $2 billion annually when the measure is fully implemented.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance