January 4, 2012

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Dawn McFarland
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional and statutory initiative concerning assessments of nonresidential real property for local property taxes (A.G. File No. 11-0087).

# BACKGROUND

## Local Property Tax

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

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

Most real property is assessed for tax purposes based on its acquisition value, plus an increase of up to 2 percent 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

$80 annually. The state provided about $450 million from the state's General Fund to reimburse local governments for this exemption in 2010-11.

- ***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).
- ***Renter's Tax Credit.*** Low-income renters may claim a non-refundable credit that reduces their state PIT liability. In 2009, the credit provided up to $120 in tax relief per household at a total cost to the state of $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 2010-11, K-12 schools and community colleges received a total of $47 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, non-agricultural real property based on its market value, as determined by county assessors. 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 2014-15. The measure also requires counties to reassess these properties at least once every three years. Residential property (single-family homes, multifamily properties, and rentals) 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 at least 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 among local entities within each county.

### Implementation Period

As noted above, the new assessment policy affects tax liabilities beginning in 2014-15. 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. The homeowner's exemption and renter's credit increases begin in 2015-16 and the business personal property exemption begins in 2016-17.

## FISCAL EFFECTS

### Effects on Tax Revenues

***Increased Property Taxes.*** In 2009-10, California property owners paid about $11 billion in property taxes for nonresidential real property as defined in the measure. We estimate that reassessing this property at fair market value would generate additional property tax revenues of about $4.5 billion annually when the measure is fully implemented. This estimate is subject to significant uncertainty, particularly regarding the performance of the commercial real estate market.

***County Administration Costs.*** From the higher tax revenues generated by the new assessment policy, counties first would claim 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 revenues by about $4 billion annually. (This represents a 5 percent increase in General Fund revenues.) In addition, local governments would receive about $450 million annually in new revenues. Under current property tax allocation laws approximately 60 percent of these funds would be allocated to cities, counties, and special districts while the remaining 40 percent would be distributed to K-12 and community college districts. The measure phases in the higher assessments over three years, so the increase in state and local revenues would be lower in 2014-15 and 2015-16 before the measure is fully implemented in 2016-17.

***Indirect Effects on Revenues.*** Owners of nonresidential real property would face increased costs due to the higher property taxes imposed by the measure, which could reduce their 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 avoid absorbing these costs 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 state revenues. Conversely, the effects of state spending increases as a result of the measure (discussed below) would have positive indirect effects on state revenues. The net indirect effect of these factors on revenues is unknown.

## Offsetting 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. Upon full implementation, 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 a state expenditure rather than as lower revenues.)

***Some General Fund Revenue Losses.*** We estimate the measure—when fully implemented—would result in a General Fund revenue loss of up to a few hundred million dollars annually 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 their state tax liabilities. Personal and corporate income tax losses could vary over time because the value of deductions depends on the interaction between commercial real estate market values and business-related income.

***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 in 2016-17.

A significant portion of the additional local government property tax revenues under the measure would go to local education agencies. In most circumstances, these revenues would offset the state's General Fund obligations to K-12 schools and community colleges under Proposition 98 by up to a few hundred million dollars annually.

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

## Net Effect on State Budget

As described above, upon full implementation of this measure, the state would receive about $4 billion of new General Fund revenues per year. General Fund costs to reimburse local governments for property tax loses would total about $1 billion per year, and higher annual minimum funding requirements to schools and community colleges under Proposition 98 would total about $2 billion. Other financial effects would tend to offset each other. The remaining $1 billion could be spent by the Legislature for any other priorities. These General Fund estimates could vary substantially over time depending on commercial real estate market conditions and Proposition 98 trends, among other factors.

## Summary of Fiscal Effects

Upon full implementation, the measure would have the following major fiscal effects:

- Annual state revenue increase of about $4 billion from higher property tax assessments on commercial and industrial property. New revenues used in part to increase state funding for schools and community colleges ($2 billion) and provide tax relief to homeowners and businesses ($1 billion).

- Annual local government revenue increase of about $450 million from higher property tax assessments on commercial and industrial property.

Sincerely,

Mac Taylor
Legislative Analyst

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Director of Finance