



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

Date Introduced:	2/23/01	Bill No:	AB 1013
Tax:	Property	Author:	Leonard
Board Position:	Neutral	Related Bills:	AB 2288 (2000) SB 82 (1991) Proposition 167 (1992)

BILL SUMMARY

This bill, with respect to property taxes, would require the reassessment of property owned by a legal entity when more than 50% of the ownership shares in that legal entity have been transferred.

ANALYSIS

Current Law

Under existing property tax law, real property is reassessed to its current fair market value whenever there is a "change in ownership." (*Article XIII A, Sec. 2; Revenue and Taxation Code Sections 60 - 69.7*)

Revenue and Taxation Code Section 64 sets forth the change in ownership provisions related to the purchase or transfer of ownership interests in legal entities that own real property. Generally, when real property is owned by a legal entity, the purchase or transfer of ownership interests in that legal entity does not trigger a change in ownership of the property. An exception to this general rule is when there is a "change in control" of the legal entity. Subdivision (c) of Section 64 defines a "change in control" to be when a person or entity acquires more than 50 percent of the ownership interests in the legal entity.

Proposed Law

This bill would amend subdivision (c) of Section 64 of the Revenue and Taxation Code to delete the language related to changes in control and instead provide that a change in ownership of the real property controlled either directly or indirectly by that legal entity occurs whenever more than 50 percent of the ownership interests in that legal entity, either individually or cumulatively, have been transferred since the last change in ownership.

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In General

Change in Ownership. California's system of property taxation under Article XIII A of the State Constitution (Proposition 13) values property at its 1975 fair market value, with annual increases limited to the amount of inflation or 2%, whichever is less, until the property changes ownership. When a change in ownership occurs, the value of the property for tax purposes is redetermined based on its current market value. The value initially established, or redetermined where appropriate, is referred to as the "base year value." Thereafter, the base year value is subject to annual increases for inflation. This indexed value is referred to as the "factored base year value."

While Proposition 13 provided that a "change in ownership" would trigger reassessment, the phrase was not defined. The Assembly Revenue and Taxation Committee appointed a special task force to recommend the statutory implementation for Proposition 13 including its change in ownership provisions. The task force findings are published in California State Assembly Publication 723, Report of the Task Force on Property Tax Administration, January 22, 1979.

Property Owned by Legal Entities. One issue the task force faced was how to apply the change in ownership provisions of Proposition 13 to property owned by a legal entity. For instance, would a transfer of ownership interests in a legal entity that owns real property be a change in ownership? The task force considered two alternatives, the "separate entity" theory and the "ultimate control" theory.

- **Separate Entity Theory.** The "separate identity" theory would respect the separate identity of the legal entity. Accordingly, for as long as the legal entity owned the property it would not be reassessed, even if all of the ownership interests in the legal entity had transferred.
- **Ultimate Control Theory.** The "ultimate control" theory would look through the legal entity for a change in "ultimate control." Under this theory, real property owned by the legal entity would be reassessed only when a single shareholder gained majority control of the legal entity through the acquisition of ownership shares.

The task force recommended that the separate entity theory be adopted, so the change in ownership definitions related to ownership interests in legal entities first placed in statute in 1979 was based on the "separate entity theory." Thereafter, subdivision (c) of Section 64 was added which provided that a change in ownership occurred whenever there was a change in control by a transfer (or transfers) of more than 50% of the total ownership interests to a single person or entity. According to "Implementation of Proposition 13, Volume 1, Property Tax Assessment," prepared by the Assembly Revenue and Taxation Committee, Assembly Publication 748, October 29, 1979, subdivision (c) was added "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfer of majority controlling ownership should result in a reappraisal of the corporation's property – an effort to maintain some parity with the increasing tax burden of residential property statewide, due to more

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rapid turnover of homes. It was also a trade-off for exempting certain transfers among 100% wholly-owned corporations¹.”

Background

Other bills that would have resulted in more frequent reassessment of property owned by legal entities include AB 2288 (Dutra) in 2000 and SB 82 (Kopp, et al) in 1991. Additionally, Proposition 167 in 1992, which addressed a number of tax related items, included a provision to modify the change in ownership definitions related to legal entities. Proposition 167 was not approved by voters.

Homeowners’ Percentage of Total Value. The following information, which is annually prepared by the Board’s Research and Statistics Section, lists the percentage of gross assessed value from properties receiving the homeowners’ exemption compared to total assessed value.

1979-80	33.6%
1980-81	36.3%
1981-82	35.4%
1982-83	34.5%
1983-84	33.6%
1984-85	32.9%
1985-86	32.5%
1986-87	32.4%
1987-88	32.5%
1988-89	32.6%
1989-90	33.1%
1990-91	32.8%
1991-92	33.0%
1992-93	34.2%
1993-94	35.3%
1994-95	36.7%
1995-96	37.6%
1996-97	38.0%
1997-98	37.9%
1998-99	38.1%
1999-2000	38.2%

¹ Section 64(b) excludes transfers of ownership interests between affiliated corporations.”

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COMMENTS:

1. **Sponsor and purpose.** This bill is sponsored by the author. Its purpose is to cause more frequent reassessment of commercial and industrial property to current market levels to assure that homeowners do not pay a disproportionate share of the state's property taxes.
2. **Any property owned by a legal entity would be subject to the new change in ownership definitions.** Although typically viewed in the context of commercial and industrial property, any real property owned by a legal entity (partnerships, limited liability corporations, corporations, etc.) would be subject to the new definition. This could include agricultural property, family farms², small businesses, and rental residential property including apartment complexes.
3. **Increasing property taxes paid by legal entities does not result, at least directly, in reducing taxes paid by homeowners.** The tax rate on the assessed value of real property is identical regardless of type or ownership -- 1% plus voter approved indebtedness. Perhaps indirectly, fewer special assessments, special taxes, Mello Roos improvement bonds, building permit surcharges, etc. would be needed if more property tax revenue was derived from property owned by legal entities.
4. **The Legislative Analyst's Office recently addressed the disparity in the frequency of reassessment of property owned by individuals versus legal entities.** In a report issued last year to the Legislature by the Legislative Analyst Office, "Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes," related to the frequency of reassessments for residential versus commercial and industrial property, the report noted,

"For residential property, this acquisition value-based system has some policy merit. Specifically, it (1) encourages stable communities and (2) ensures no sharp increases in taxes from year to year (of particular concern for senior citizen homeowners on fixed incomes). At the same time, however, new homeowners – both first time homebuyers and those relocating - bear a disproportionate share of the residential property tax burden. It is only after a number of years of homeownership that the financial benefits of the acquisition assessment system accrue to homeowners.

The same benefits of the acquisition value system exist in terms of commercial and industrial property; however, the disadvantages of this policy for businesses in a competitive economy are somewhat troubling. The system can present an economic barrier to entry for new businesses. If a competitor has been in the same location for a number of years, a new business faces higher operating

² The parent-child change in ownership exclusion does not apply to ownership interests in legal entities. Property can be taken out of the legal entity for a direct parent to child transaction. However, there is a one million dollar cap on the value of property that may be transferred without reassessment.

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costs. This can discourage the formation of new businesses and reduce competition.”

5. Opponents of more frequent reassessment of property owned by legal entities note that ultimately the higher property taxes paid by legal entities that own California real estate would result in:

- higher cost of goods and services,
- loss of business growth to other states and countries,
- reduction of California competitiveness,
- decrease in profits to owners and investors including retirees,
- lower wages for employees of legal entities,
- increase in the size of government, and
- increase in government employee salaries

6. How would the change in definition cause more frequent reassessments?

Under current property tax law, an entity may undergo a complete ownership turnover in a series of transfers, none of which exceed 50%, and the real property owned by the legal entity may not be reassessed. Thus, it is possible that real property owned by a legal entity since 1975 has never been reassessed and may never be reassessed as long as the current definitions hold. Under existing law, for real property that is owned by legal entities, as long as no one person acquires more than 50% of the ownership interests in the legal entity, thereby causing a “change in control,” the property will not be reassessed. Under this bill, as soon as individually or cumulatively more than 50% of the ownership interests in the legal entity is sold or transferred, then all the real property owned by the legal entity would be reassessed. Thus under this bill, rather than tracking a single controlling owner, the potentially millions of shares of ownership interests in legal entities that own Californian real estate would be tracked.

7. How often would property owned by legal entities be reassessed? In practical application, most real property owned by a corporation whose stock is owned and traded by the public would likely be frequently reassessed to current market values because of the high turnover of stock in these companies. It is theoretically possible that a corporation could be reassessed once a year or more. With respect to real property owned by privately held corporations and partnerships, there would be less frequent reassessment of these properties, since there would generally be fewer turnovers of ownership interests.

8. Property taxes paid by legal entities generally increase over time. Businesses, unlike homeowners, also pay property taxes on their personal property holdings. Their personal property is assessed every year at its current market value. Additionally, as businesses grow and expand, any real property that a legal entity newly constructs or acquires is reassessed to current market value. Further, mergers and takeovers of corporations can result in reassessment triggers.

9. The Administrative Workload. County assessors' offices are not staffed at levels to handle the increase in real estate appraisal workload that this bill would create. It

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would likely take many years to determine which legal entities have had a change in ownership and to then appraise the real property owned by the legal entity.

- Properties owned by legal entities are generally the most complex type of property to appraise. In addition, evaluating whether a legal entity has had more than a 50% turnover in ownership interests would likely require a substantial commitment of resources, and would presumably lead to an increase in the number of assessment appeals and lawsuits.
- Either the Legal Entity Ownership Program (LEOP) division of the Board of Equalization or county assessors would need to develop a comprehensive set of written procedures for identifying and tracking the existence of all legal entities (corporations, partnerships, and limited liability corporations etc) in all counties each year.
- The Board and the Franchise Tax Board (via a question on the income tax return) currently have certain roles in identifying, tracking, and transmitting to counties changes in control and changes in ownership of legal entities that own property. This would likely be insufficient under the new definitions.

10. This bill represents a major overhaul of the property tax administration system as it relates to property owned by legal entities. This is a fundamental policy issue with substantial administrative and implementation issues that would require resolution. Prior analyses of this concept for Senate Bill 82 in 1991 and Proposition 167 in 1992 noted the numerous technical issues with periodic reappraisal of legal entities and the special difficulties of tracking stock ownership interests. If this policy change is desired by the Legislature, then it may be appropriate to delay the implementation and create a task force with members of industry, the Board, assessors, the legislature, academics, and stock industry experts, etc. to determine and resolve these implementation issues.

COST ESTIMATE

Pending, but ultimately depends on Board's role in tracking ownership interests in legal entities..

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Under current property tax law, an entity may undergo a complete turnover in a series of transfers, none of which exceed 50%, and the real property owned by the legal entity may not be reassessed. This bill would essentially require property owned by legal entities to be reassessed whenever more than 50 percent of the ownership interests in the legal entity is transferred either individually or cumulatively.

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This bill would necessitate that real property owned by legal entities be reassessed more often than it is under current law. This would result in an increase in assessed value and an increase in property tax revenue.

It is not possible to estimate the increase in property tax revenues with any degree of certainty. We do not know how much property is owned in California by legal entities that would be affected by this proposal. We do not know the current assessed value of this property nor do we know the actual market value of this property. We have no information on how often these properties would be reassessed based on the change in ownership provisions of this proposal.

At best, we can attempt to estimate what the revenue effect would be if all of the property that might potentially be subject to this proposal were to be reassessed at its actual market value rather than at the current assessed value. One of the factors that hampers us from making this estimate is a lack of information regarding the breakdown of current assessed values by property type. In 1997, we attempted to estimate the breakdown of the assessed value of locally assessed real property by property type. This breakdown was based on information from the U.S. Department of Commerce's publication Census of Governments. This information is somewhat dated, but more current information is not available. This breakdown was as follows:

<u>Property Type</u>	1996-97 Assessed Value (in billions)
Single family residential	\$ 920.9
Multiple family residential	187.5
Agricultural	71.2
Commercial/Industrial	442.0
Vacant Lots/Other	<u>98.8</u>
Total	\$1,720.4

If we assume the same percentage breakdown would apply to the assessed values on the 2000-01 property tax rolls, the breakdown would be:

<u>Property Type</u>	2000-01 Assessed Value (in billions)
Single family residential	\$1,152.1
Multiple family residential	234.6
Agricultural	89.1
Commercial/Industrial	553.0
Vacant Lots/Other	<u>123.6</u>
Total	\$2,152.4

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We assume that this proposal would have minimal effect on single family residential property. While there would be some agricultural property that may be owned by legal entities, the restrictions on this property would probably not cause a great deal of reassessment under this proposal. The vacant land/other category is a hodgepodge, a sizeable portion of which is land in transition, i.e. about to be developed into residential or commercial/industrial. We will assume that half of this category is owned by legal entities that would be subject to the provisions of this proposal. For purposes of this estimate, we will assume that all of the multiple residential property and commercial/industrial property would be affected. Including all of this property will overstate the effect since we know that a portion of this amount would not be affected by this proposal. Therefore, the following amount should be treated as a cap on the potential revenue effect of this proposal. Based on these assumptions, we can estimate the amount of property potentially affected as follows:

<u>Property Type</u>	2000-01 Assessed Value (in billions)
Multiple family residential	\$ 234.6
Commercial/Industrial	553.0
Vacant Lots/Other	<u>61.8</u>
Total	\$ 849.4

The next step is to estimate the market value of this property. The Board does a study each year to determine the effective assessment level for commercial/industrial property in order to determine the assessment level for rail transportation property. The latest study, completed in May 2000 was based on information from the 1998-99 assessment roll. That study found that the effective assessment level for locally assessed real commercial/industrial property was 71.95%. If we apply this ratio to the assessed value estimated at \$849.4 billion, we calculate the market value of this property to be \$1,180.5 billion, an increase of \$331.1 billion. The property tax revenue at 1% tax rate on this increase in value would be \$3.3 billion. However, this figure is, as noted previously, the **maximum** amount of increased property tax revenue that could be expected from this proposal. It is clear that the actual amount would be less than this, as not all of the property included in the above analysis would be subject to the provisions of this bill, but how much less is impossible to determine. It also should be noted that whatever the amount might be, it will be added over a number of years, as the various properties are reassessed based on the proposed change in ownership provisions of this proposal.

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Revenue Summary

It is not possible to determine the specific revenue impact of this proposal as the information regarding the number of properties affected, the current assessed value of these properties, the actual market value of these properties or the turnover rate based on the change in ownership provisions of the bill is not available. The analysis presented above is an attempt to estimate the order of magnitude of potential revenue gain of this proposal.

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