Senate Constitutional Amendment 5 (Hancock and Mitchell)
Date: 07/16/15
Program: Property Taxes
Sponsor: Authors
California Constitution Article XIII 3.1, Article XIII A, Section 2 and 2.5
Effective: If approved by voters.

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Summary: Subject to voter approval, requires commercial/industrial property to be annually assessed at fair market value (FMV) and exempts the first $500,000 of business personal property (BPP) from tax.

Purpose: To require property taxes on commercial and industrial property to be based on FMV, thus removing this class of property from Proposition 13's assessed value limitations.

Fiscal Impact Summary: The proposal for annual reassessment of commercial/industrial property could result in a revenue gain of more than $5 billion annually. The proposed business personal property exemption could result in a revenue loss of $1 billion annually.

Existing Law: For property tax purposes, real property is reassessed from its Proposition 13 protected value (called a "base year value (BYV)") to its current market value only if a change in ownership occurs.[1]

Proposed Law: If voter-approved, this constitutional amendment would do the following:

Business Personal Property Exemption. Beginning on January 1, 2019, this bill creates a BPP exemption. It would exempt from property tax the first $500,000 of a taxpayer's tangible personal property used for business purposes. This exemption amount may only be reduced by another constitutional amendment.

Annual Reassessment. Beginning with the 2018–19 fiscal year, this bill requires the assessor to set assessed values for commercial/industrial property, as defined, at fair market value (FMV) as of the lien date (January 1). The bill directs the assessor to transition all commercial and industrial properties from BYV to FMV over a two-year period. Property owners would pay a portion of any increase in property tax due in the first and second years after initial reassessment to fair market value, as provided. The portion not paid after the first two years is "forgiven."

Initial Transition Years. The bill requires an inflation factor to be applied during the initial reassessment transition period. It is unclear what assessed value the assessor is to enroll during the transition period. This is because for specific fiscal years, the bill requires an inflation factor to be applied to a prior year's FMV. That requirement conflicts with the bill's requirement to assess at current year FMV. In other words, property cannot at once be assessed at FMV and the prior year's FMV adjusted for inflation. If the requirement to assess at FMV is interpreted to supersede the requirement to assess at a prior year's FMV adjusted for inflation, all property owners (except for qualified owner-operators) would pay taxes based on current year FMV and would not be entitled to forgiveness for either the 2020 lien date or 2021 lien date.

[1] California Constitution Article XIII A, Sec. 2.

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Property Assessments	2018-19	2019-20	2020-2021
Oldest ½ of Assessment Roll	**Assessed Value** 2018 FMV **Tax** 1/3 of increase to 2018 FMV	**Assessed Value** 2018 FMV x 2% **Tax** 2/3 of increase to 2018 FMV	**Assessed Value** 2018 FMV x 2% X 2%[2] or 2020 FMV[3]? **Tax** Full Increase to 2018 FMV or 2020 FMV ? *Unclear*
Newest ½ of Assessment Roll	**Assessed Value** BYV	**Assessed Value** 2019 FMV **Tax** ½ of increase to 2019 FMV	**Assessed Value** 2019 FMV x 2%[4] or 2020 FMV[5]? **Tax** Full increase to 2019 FMV x 2% Or 2020 FMV? Unclear

Owner-Operator Partial Exemption. Eligible commercial/industrial property owners who operate an on-site business would be eligible for a partial exemption from tax on that portion of the assessed FMV that exceeds BYV by 25% as so described for the first 5 years. If FMV versus BVY does not exceed 25%, no exemption is allowed. Eligibility is limited to property owners with statewide holdings of $3 million or less.

In General: **Property Tax System.** In 1978, voters changed California's property tax system with the approval of Proposition 13. Under this system, property is reassessed to its current market value only after a change in ownership or new construction. Generally, the sales price of a property is used to set the property's assessed value, and annual increases to that value are limited to the rate of inflation, not to exceed 2%. Under this system, a property's assessed value is based on its 1975 fair market value until the property changes ownership. Thereafter, annual assessed value increases are limited to 2% or the inflation rate, whichever is less. When the property changes ownership, it is reassessed to its current market value and future increases to that value are subject to the same limits.

[2] Article XIII A Sec. 2.5(b)(2).
[3] Article XIII A Sec. 2.5 (c)(1).
[4] Article XIII A Sec. 2.5 (c)(1).
[5] Article XIII A Sec. 2.5 (c)(2).

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Change in Ownership. While Proposition 13 provided a "change in ownership" reassessment trigger, it did not define this key phrase. The Assembly Revenue and Taxation Committee appointed a special Task Force to recommend the statutory implementation for Proposition 13 and define change in ownership. The Task Force consisted of 35 members, including legislative and BOE staff, county assessors, public and private sector attorneys, and trade associations.

The Task Force published its findings in **Report of the Task Force on Property Tax Administration,** California State Assembly Publication 723, January 22, 1979. The Assembly Revenue and Taxation Committee also published a report that contains additional background on defining change in ownership called **Implementation of Proposition 13, Volume 1, Property Tax Assessment,** California State Assembly Publication 748, October 29, 1979.

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

- **Separate Entity Theory.** The separate entity theory respects the separate identity of the legal entity. Accordingly, as long as the legal entity owns the property it will not be reassessed, even if all of the ownership interests in the legal entity transfer.
- **Ultimate Control Theory.** The ultimate control theory looks through the legal entity to determine who holds the ownership interests and thus, who has "ultimate control" of the legal entity. Under this theory, real property owned by the legal entity is reassessed only when a single holder of ownership interests gains control of the legal entity through the acquisition of a majority of the ownership interests.

The Task Force recommended the separate entity theory be adopted for two reasons. The Report states:

> (a) The <u>administrative and enforcement</u> problems of the ultimate control approach are monumental. How is the assessor to learn when ultimate control of a corporation or partnership has changed? Moreover, when the rules are spelled out (and the Task Force actually drafted ultimate control statutes) it became apparent that, without trying to cheat, many taxpayers, as well as assessors, would simply not know that a change in ownership occurred. The separate entity approach is vastly simpler for taxpayers and assessors to understand, apply, and enforce. Transfers between individuals and entities, or among entities, will generally be recorded. Even if unrecorded the real property will have to be transferred by unrecorded deed or contract of sale. Taxpayers can justifiably be expected to understand that a <u>transfer of real property</u> is a change in ownership and must be reported to the assessor.

Tax Burden. The Task Force expressed concern that a tax burden shift to residential taxpayers could occur under its separate entity theory since commercial and industrial property changes ownership less frequently than residential property. The definitions originally proposed for legal entities using the separate entity theory were chosen to mitigate administrative difficulties. Because of this concern, the Task Force proposed that the Legislature study the idea of a constitutional amendment to periodically appraise commercial and industrial property at current market value noting:

> [s]uch a constitutional change would also result in far greater simplicity in the treatment of legal entities. If commercial and industrial properties were to be periodically reappraised for reasons <u>other than</u> change in ownership, the difficult and controversial policy issues in choosing between the 'ultimate control' approach or 'separate entity' approach, outlined previously, would largely be avoided. The Task Force commends the principle of such a change to the Legislature for additional study.

Legislation and Initiatives. The table below summarizes prior attempts to require periodic and annual reassessments, create a split tax rate, or create a business personal property exemption.

Year	Bill	Summary
2003	ACA 16 (Hancock)	**Annual Reassessment.** Annually reassess nonresidential, nonagricultural property.
2009	Dropped	**Split Tax Rate.** Extra .55% for nonresidential real property excluding commercial agricultural property. **Homeowners' Exemption.** Increase to $14,000 **Business Personal Property.** Exempt first $1,000,000. (Submitted by Roberta B. Johansen and Karen Getman)
2009	Dropped	**Periodic Reassessment.** Every 3 years reassess nonresidential real property excluding commercial agricultural property. **Homeowners' Exemption.** Increase to $14,000 **Business Personal Property.** Exempt first $1,000,000. (Submitted by Roberta B. Johansen and Karen Getman)
2005	Dropped	**Annual Reassessment.** Annually reassess all nonresidential real property excluding property used for commercial agricultural production. (Submitted by Roberta B. Johansen and James C. Harrison)
2005	Dropped	**Annual Reassessment.** Annually reassess nonresidential real property excluding property used for commercial agricultural production **Business Personal Property.** Exempt first $500,000. (Submitted by Lenny Goldberg)
2005	Dropped	**Annual Reassessment.** Annually reassess nonresidential real property excluding property used for commercial agricultural production. **Business Personal Property**. Exempt first $500,000. (Submitted by Wayne Ordos)
2005	Dropped	**Split Tax Rate.** Increase tax rate on commercial real property except commercial residential rental property by either .30% or .50%. (Submitted by Roberta B. Johansen and James C. Harrison)
2005	Dropped	**Split Tax Rate.** Increase max tax rate from 1% to 3% on nonresidential property; counties set the actual rate at no less than 2%. Limit the 1% tax rate on residential property to the first $2 million. (Submitted by K. Heredia)
2004	Signatures Collected & Initiative Dropped	**Split Tax Rate.** Increase tax rate to 1.5% nonresidential real property excluding property used for commercial agricultural production. Proponent: California Teachers Association & Rob Reiner

Change in Ownership Legislation. The table below summarizes efforts to trigger more frequent reassessments of legal entity owned property.

Year	Bill	Summary
2015	SB 259 (Bates)	Reassess when 90% of ownership interests transfer in a single planned transaction in a 3 year period.
2014	AB 2372 (Ammiano)	Reassess when 90% of ownership interests cumulatively transfer.
2013	AB 188 (Ammiano)	Reassess when 100% of ownership interests transfer in a single transaction in any rolling 3 year period.
2011	AB 448 (Ammiano)	Reassess when 100% of ownership interests transfer in a single transaction in any rolling 3 year period.

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Year	Bill	Summary
2010	AB 2492 (Ammiano) 5/18/10 Version	Reassess when 100% of ownership interests transfer in a single transaction.
2010	AB 2492 (Ammiano) 4/8/10 Version	Reassess property owned by publicly traded companies every 3 years (rebuttable presumption). Property owned by other types of legal entities reassess in proportion to the percentage of ownership interests in the legal entity transferred.
2005	SB 17 (Escutia) As Amended	Reassess when more than 50% of the ownership interests transfer in a calendar year (excluding publicly traded companies).
2005	SB 17 (Escutia) As Introduced 12/06/04	Every 3 years reassess property owned by publicly traded companies (rebuttable presumption). Property owned by other types of legal entities reassessed in proportion to the percentage of ownership interests in the legal entity transferred.
2003	SB 17(Escutia)	Legislative intent to redefine change in ownership for nonresidential commercial and industrial property.
2003	SBx1 3 (Escutia)	Legislative intent to redefine change in ownership for nonresidential commercial and industrial property.
2002	SB 1662 (Peace)	Reassess nonresidential property when cumulatively more than 50% of ownership interests transfer. Broaden the state and local sales and use tax base and reduce both the state and local sales and use tax rate. (Legislative intent)
2001	AB 1013 (Leonard)	Reassess when more than 50% of ownership interests transfer.
2000	AB 2288 (Dutra)	Every 3 years reassess legal entity owned property. (Rebuttable presumption change in ownership occurred.) Possible income tax credit to homeowners based on fair market value of homes from additional revenue. Reduce the sales and use tax rate by 0.25%.
1991	SB 82 (Kopp)	Reassess when cumulatively more than 50% of ownership interests transfer.
1992 Prop. 167	Failed 41.16% - 58.84%	Among various tax related items, included a provision to modify legal entity change in ownership definitions. Proponent: California Tax Reform Association

Other related legislation.

Year	Bill	Summary
2008	AB 2461 (Davis)	**Split Roll – Revenue Estimate.** Require the BOE to study the revenue generated if nonresidential commercial property, as defined, is reassessed at its fair market value.
2012	AB 2014 (Ammiano)	**Legal Entity Task Force**. Convene task force to update the work done by the 1979 task force.

Commentary: This analysis is primarily limited in scope to the measure's administrative implementation issues.

1. **What is a "split roll"?** This legislation, which calls for more frequent reassessment of commercial and industrial property, is said to create a "split roll." A "split roll" means taxing certain types of property according to a different value standard or tax rate. The “roll” refers to the assessor’s “assessment roll.” The annual assessment roll lists all property in a county and includes details such

as the owner's name and assessed value for the fiscal year. Assessed values are broken down into three components: land, improvements, and personal property. Prior attempts to redefine legal entity change in ownership is often described as split roll legislation. A true "split roll" is only possible with a constitutional amendment, such as this bill proposes by splitting off commercial/industrial property and requiring annual fair market value- based assessments.

2. **Removes Proposition 13's assessed value limitations from commercial/industrial property.** After the transition period ends, this bill requires the assessor to annually reassess commercial/industrial property at its fair market value on January 1. All other real property would be assessed at its acquisition value with an annual inflation adjustment. Proposition 13's 1% tax rate limit continues to apply to all properties.
3. **The original 1978-79 Proposition 13 Task Force proposed that the Legislature study a constitutional change to *periodically* reappraise commercial and industrial property.** The Proposition 13 Task Force considered and debated the issue of how to treat transfers of interests in legal entities. The Task Force recognized the effect of its decisions over the long term noting "(t)he Task Force admits that some of its own recommendations, such as those regarding legal entities, while the best of a seemingly 'no-win' choice of options and adopted to mitigate administrative difficulties, may, in the long run, further exacerbate this [tax burden] shift to residential property because it will result in fewer potential commercial and industrial property transfers being recognized for reappraisal purposes." Consequently, the Task Force proposed that the Legislature later study a constitutional change to *periodically* reappraise commercial and industrial property. This bill proposes annual reassessments. Annual reassessments of these properties, rather than a less frequent reassessment schedule, will require assessors to use mass appraisal techniques to complete the workload.
4. **Legal entity change in ownership law continues to apply to residential property and agricultural property.** The BOE would need to continue to operate the Legal Entity Ownership Program (LEOP) to track when properties owned by legal entities require reassessment under current change in ownership laws. For example, partnerships that own homes, LLPs that own apartment complexes, and agricultural land owned by legal entities.
5. **Administrative Workload.** Appraisal of commercial/industrial properties is very complex, and county assessors' offices would need to hire real estate appraisers to assess these properties annually, as well as defend the annual reassessments in the appeals process**.**
6. **Transition Period.** The mass reassessment of all commercial/industrial properties over a two-year period is a significant appraisal challenge for any county to undertake. The bill's other provisions, such as the inflation factoring, the forgiveness, and the exemption, are operative in the first to five years compound this administrative challenge. These short-term provisions add layers of complexity unrelated to the bill's primary long-term goal of transitioning to FMV-based assessments and divert the assessor's focus from the critical tasks necessary to successfully make the transition. The critical tasks include: (1) identify affected commercial/industrial property, (2) identify potentially affected residential and agriculture property, (3) make decisions related to gray-area property classification issues, (4) address and resolve issues involving mixed-use properties, (5) prorate existing BYVs to create new BYVs for portions of real property that remain under Prop. 13 protections, (5) update and gather data on properties not reassessed for decades, and (6) appraise property.
7. **Should short-term, detailed administrative provisions be included in the constitution**? Much of the constitutional language relates to the special provisions intended for the transition period. Once the transition period ends, these provisions become inapplicable but will require a vote of the people to remove. Moreover, the constitutional provisions are quite detailed, and appear to be conflicting. The author may wish to consider making the constitutional language more general and higher level. Implementing statutes could then flesh out the details if the constitutional amendment is approved. This would give county administrators the flexibility to implement the core components in the most cost effective manner possible.

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8. **Temporary Forgiveness and Temporary Exemption.** Owner-operators are provided a temporary "exemption" under Article XIII, while Article XIII A allows taxes to be "forgiven." To simplify administration and harmonize the provisions, the author may wish to consider administering one type of temporary relief, and adjusting it depending on whether the property owner is an owner-operator. Alternatively, the author may wish to consider delaying the transition to FMV assessments for owner-operators for five years. Further, an exemption expressed in terms of assessed value might be preferable to tax forgiveness expressed in tax dollars. "Exemptions" are administered by the assessor and fit within the existing administrative procedures for preparing the assessment roll which ultimately determines the basis of the property tax bill.

9. **Providing two different types of temporary relief is administratively confusing and complex.** Is a distinction intended? Does the assessor administer an "exemption" measured in terms of assessed value while the auditor/tax collector administers the "forgiveness," in terms of tax dollars by applying the discounts (i.e., 1/2, 1/3, 2/3) on the tax bill after the assessor applies the exemption? This would likely require costly temporary reprogramming of computer systems by multiple county departments: assessor, auditor, and tax collector. Since the exemption is in Article XIII and forgiveness is in Article XIII A, it raises the question of the interplay between the two sections. Are they mutually exclusive, or, can both be used? Depending on the unique facts of each property, is it mathematically possible that the tax savings might be better under the exemption provisions than under the forgiveness provisions, or vice versa, since the methods of calculation differ? For the owner-operator it is only that portion *above* 25% that is eligible for exemption. For others, *any* increase is eligible for forgiveness of 2/3 in year 1, and 1/3 in year 2 (or 50% in year 2). For example:

   - An owner-operator with a 24% Assessed Value (AV) increase isn't eligible for a five-year exemption. Does this property owner then default to forgiveness (2/3 or 1/3 (or 1/2) of the 24% increase) or does the property owner get neither an exemption nor forgiveness?
   - If an owner-operator had a 26% AV increase does the owner get both an "exemption" for the 1% increase and "forgiveness" (2/3 or 1/3 (or ½)) for the 25% increase?

10. **The property tax basis in the transition period is unclear.** The assessed value the assessor is to enroll during the transition years is unclear given conflicting language related to applying an inflation factor to a prior year's fair market value and the requirement to assess at current fair market value. The table below attempts to illustrate the complexities and the administrative uncertainties this bill proposes:

	18-19 **BYV:** **$100,000** **FMV:** **$126,000** **Inflation 2%**	**19-20** **BYV:** **$102,000** **FMV:** **$128,000** **Inflation 2%**	**20-21** **BYV:** **$104,000** **FMV:** **$110,000** **Inflation 2%**	**21-22** **BYV:** **$106,000** **FMV:** **$126,000** **Inflation 2%**	**22-23** **BYV:** **$108,000** **FMV:** **$130,000** **Inflation 2%**
First Half	AV/FMV:$126,000 "Forgiven" Tax @ 1% Rate: 2/3 of $260	AV: $126,000 x 1.02 Forgiven: 1/3 of ?	AV: ? Forgiven: 0%	AV: ?	AV/FMV: $130,000

	18-19 **BYV:** **$100,000** **FMV:** **$126,000** **Inflation 2%**	**19-20** **BYV:** **$102,000** **FMV:** **$128,000** **Inflation 2%**	**20-21** **BYV:** **$104,000** **FMV:** **$110,000** **Inflation 2%**	**21-22** **BYV:** **$106,000** **FMV:** **$126,000** **Inflation 2%**	**22-23** **BYV:** **$108,000** **FMV:** **$130,000** **Inflation 2%**
First Half & Owner Operator	AV: $126,000 -1000 = 125,000? Y1 Exemption: **$1,000 AV?** Forgiven: 2/3 of ?	AV: ? Y2 Exemption: ? Forgiven: 1/3 of ?	AV:? Y3 Exemption: ? Forgiven: 0%	AV:? Y4 Exemption: ?	FMV: $130,000 Y5 Exemption: ? AV: ?
Second Half	AV/BYV: $100,000	AV: $128,000 Forgiven: 50% of $260 (26,000 x 1%)?	AV:? Forgiven: 50% of ?	AV:?	AV/FMV: $130,000

11. **Implementation uncertainties related to the owner-operator exemption.** As noted below, the temporary provisions are administratively complex and require significant resources to identity those properties eligible for the exemption and/or forgiveness. Does the cost to administer outweigh the additional revenue ultimately collected? As previously noted, for efficient administration, the author may wish to identify those properties that are owner-operated and instead delay the operative date of the annual reassessment five years after 2019.

The $3 million cap

- Are residential properties (principal place of residence and rentals) included in the $3 million cap?
- Does the $3 million cap include business personal property? The bill states "entire" property, including land and buildings (an improvement). The language is placed adjacent to the personal property exemption section. The bill is silent.
- How would property owners know if their current market value holdings are $3 million or more? At best, short of hiring their own real estate appraiser, they could only estimate.
- Is the $3 million cap based on one point in time? Does the value of the property owner's real estate holdings in the first year apply to the entire 5-year period? What happens if a property owner acquires more property and owns $5 million of property in the third year? Or if market values increase to above $5 million in subsequent years?

Measuring 25%

- Is the 25% assessed value increase based on one point in time? If not, what happens if the AV increase is only 5% in year 4 because FMV falls?
- How is the exemption applied if values drop? Is it possible that a Prop. 13 /Prop. 8 assessment could be dropped even lower during the 5-year exemption period because of the way the exemption is calculated and depending on how this section of the Constitution is interpreted?
- Does the exemption extend to a new property owner in years 2-5? The exemption appears to expire based on time rather than ownership. Does change in ownership law continue to apply in years 2-5 for purposes of calculating the "portion exceeding 25%?"
- Liable/Not Liable. The liable/not liable language implies the 5-year exemption is conditional and exemption savings might accrue and become payable at a later date. It would be clearer to delete paragraph (b)(2) of Section 3.1 as it appears unnecessary.

Owner-operators

- The terms "majority of property" and "own business purpose" are not defined. Does the term refer to a majority of property value or a majority of square footage of property? Is a distinction intended between the terms "operate a business" and "use…for own business purpose?"

Exemption Amount - Five Years

- Proponents have indicated that the exemption is intended to be a *one-time* five year "exemption." However a one-time exemption that lasts five years doesn't fit in an annual fair market value system because every year after the transition, the assessment is reset at FMV. Section 3.1(b) uses the phrases exempt "for a period of five years following reassessment" and "expire five years from its initial application." It also uses the phrase "as an operation of the measure" and "the reassessment of the property as a result of this measure."

The "reassessment" as a result of this "measure" could be interpreted in two ways:

- the <u>initial</u> reassessment from BYV to FMV or
- the <u>annual</u> reassessment requirement to assess at FMV

If it means the "initial reassessment," then it appears to require a *fixed* exemption [(2018 BVY x 125%) – 2018 FMV] to be applied to the FMV (which changes each year) for each of the first five years.

If it means the "annual reassessment," then a *variable* exemption [(20xx BYV x 125%) – 20xx FMV] applies to FMV for each of the first five years.

12. **Using the assessor parcel number system.** To simplify administration, to the author may wish to explicitly state that any special provision applies on a per parcel basis, and to define parcel as any parcel that has a separate assessor's parcel number. A parcel of real property that is not legally subdivided may consist of more than one assessor parcel number, as is the case with contiguous properties under the same ownership. The assessor's parcel number system is a method of identifying property for tax purposes. The assessor's parcel number does not always relate to a legally subdivided "parcel."

13. **Statewide vs. Countywide limitations.** To simplify administration, any limitation, such as the $3 million dollar cap (perhaps based on prior assessed value rather than current FMV) and the "first" $500,000 personal property exemption would be best implemented by each county independently (i.e., countywide basis). A countywide limitation allows each county to make decisions independently based on the data that is already in its possession. Statewide limitations are more difficult to administer, delay decision making, and require costly roll corrections because of information acquired from multiple counties after the fact.

14. **Special assessment procedures for specific types of property described in Article XIII of the California Constitution should be explicitly addressed.** To be clear, the legislation should explicitly state that annual fair market value standard does not apply to properties subject to valuation procedures outlined in Article XIII. This includes:

    - **Open Space Land (Williamson Act)**. Enforceably restricted open space land for recreation, enjoyment of scenic beauty, use or conservation of natural resources, or production of food or fiber. *(Art. XIII, Sec. 8)*
    - **Historical Property.** Enforceably restricted property with historical significance. *(Art. XIII, Sec. 8)*
    - **Certain Golf Courses**. Nonprofit golf courses of 10 acres or more. *(Art. XIII, Sec. 10)*
    - **Taxable Government Owned Property.** Taxable property owned by a local government that is located outside its boundaries. *(Art. XIII, Sec. 11)*
    - **Timberland Production Zones.** Contractually restricted property to grow and harvest timber. *(Art. XIII, Sec. 3(j))*
    - **State Assessed Property.** This property is already assessed at annual fair market values. The value standard for any property assessed by the Board of Equalization is annual current fair market value. This generally includes property owned or used by telephone carriers, wireless carriers, radio-telephone carriers, gas, electric, and water companies, pipeline companies, railroad companies, railroad maintenance and private railroad cars.

15. **Defining Residential Properties.** The bill defines "residential property" as including "both single-family and multiunit structures, and the land on which such structures are constructed or placed, that are intended to be used and are used for long-term residential occupancy, but shall exclude hotels, motels, and similar structures that are used primarily for transient and nonpermanent residence." The term "transient" isn't defined. Should residential zoning, rather than actual "use" and "long-term" use be the bright line test to avoid uncertainty? The residential property definition is ambiguous, and will require implementation decisions to be made with respect to the following properties:

    - Bed and Breakfast (owner-occupied) establishments
    - Second homes with short-term occupancy
    - Short term vacation rental homes (Airbnb, vrbo, homeaway, etc.)
    - Condemned or damaged home
    - Vacant home on lien date
    - Campgrounds
    - Timeshares
    - Assisted living facilities, convalescent homes, and board and care homes.
    - Half-way homes, crisis housing.
    - Hotels (some hotels sell individual units as condominiums or time shares)
    - Motels (some motels are long term rentals) some motels provide long term housing for low income tenants.

    Given the tax implications, the pressure on tax administrators to classify property as "residential property" in any gray area will be significant.

16. **Vacant residential land and lots.** It appears *vacant* residential land, including an empty lot in a residential subdivision, would be subject to annual FMV assessments. Once construction begins, how is construction in progress treated? Do land values revert from FMV to BYV from the last change in ownership? Is the land BYV established at the date of completion? To avoid these issues, should residential use zoning, rather than actual use be the bright line test to avoid these complications?

17. **Other residential issues.** Would the assessor reassess at current FMV the second lot of a home on a double lot with separate assessor parcel numbers?

18. **Nontraditional residences.** Manufactured homes and manufactured home parks are not specifically addressed. The phrase "or placed" in the definition of residential property is intended to refer to manufactured homes. Floating homes and floating home marinas are not specifically addressed. Most property tax provisions specify the terms, manufactured homes and floating homes where applicable.

19. **Mixed Use Properties.** Parcels of land may have both residential and non-residential elements depending on the types of structures located there. In addition, some properties have a mixture of residential and non-residential within the same structure, such as live-work spaces and lofts. Assessors would need to separate existing assessments and establish some sort of method to allocate land values for the residential/nonresidential elements.

20. **Defining "Commercial Agricultural Production."** Property owners may be motivated and tax administrators may be pressured to classify property as "used for commercial agricultural production" given the potential tax implications. The bill defines "commercial agricultural production" as real property that is "used and zoned for producing agricultural commodities." The author may wish to specifically delineate in the constitutional provisions any property types that are not intended to be subject to reassessment under this bill. Many of the words used to define "commercial agricultural production" could be prone to differing interpretations, including:

    - "Used"
    - "Commercial"
    - "Agricultural"
    - "Producing"
    - "Commodities"

21. **A number of agriculture-related properties have a commercial/industrial element.** The meaning of the term "agricultural" is not universally understood. Some interpret the term broadly, such as in property tax matters, and others interpret it narrowly. For example, to some agricultural refers only to farming land (field crops, vegetable crops, fruit and nut orchards), vineyards (but not wine making facilities), and farmland and orchards (but not any farm-related outbuildings and barns or any processing or packing facilities.) To others, it has a broad scope, including all livestock, dairy, poultry, floriculture, dry grazing land, dairy operation, nurseries, greenhouses, horse breeding, horse stables, poultry processing, commercial egg production, cheese production (goats, cows, cheese making facilities), meat processing and packing, rice silos, packing sheds, hay storage, and produce stands. The phrase "used for commercial agricultural production" could be extended beyond the cultivation of land or the growing, raising, or gathering of commodities and the raising of livestock, if that is the author's intent.

22. **Agricultural "Use" Requirement.** The definition only applies to property that is "used." If water conditions do not allow planting or require that an orchard be untended or a field left fallow, is it still subject to annual FMV? What if a property owner is unable to actively farm operate a dairy or raise livestock due to illness or funding problems? Should zoning rather than use be the primary factor in determining whether a property is subject to annual assessment to FMV?

23. **The reference to residences in the agricultural provisions seems unnecessary and is confusing.** As residential structures already are excluded from annual FMV assessment, it is recommended that the reference to residences be deleted.

24. **Exclude all Williamson Act properties completely?** As noted above, Article XIII, Section 8 provides special assessment provisions for land under open space contracts. Excluding all these properties in total, would provide a bright light test and a measure of certainty for property owners and tax administrators. Land under a Williamson Act contract can be used for compatible uses. Uses that are related directly to the production of commercial agricultural product, such as harvesting,

processing or shipping typically are considered compatible.

25. **The parent-child change in ownership exclusion would be restricted to residential and agricultural properties**. The parent-child exclusion would not apply to commercial/industrial properties since they would no longer be subject to change in ownership law.

26. **Business personal property exemption.** Placing the exemption details in the Constitution will make any modification difficult. Furthermore, the constitutional language will state that "the Legislature" shall not change its application. As a first-time partial exemption, inevitably there will be issues that require clarifying amendments. While the Constitution will bar the Legislature from making statutory changes, it doesn't bar the BOE from modifying regulations that implement the constitutional provisions.

- Placing the exemption in Article XIII makes the exemption also apply to state assessees and private railroad car owners. Unlike local assessees, these taxpayers are already subject to annual assessments. Is additional tax relief intended?
- The author may wish to expressly state that the exemption does not apply to personal property currently subject to any in lieu property tax, such as the vehicle license fee, the private railroad car tax, the timber yield tax, and any in lieu tax levied on commercial coaches or mobilehomes.
- The term "each taxpayer" is not defined for purposes of limiting the exemption. In addition, the basis of the exemption is not specified. Does it apply to each taxpayer per parcel? Or does it apply to each taxpayer on a statewide or countywide basis? If on a per-parcel basis, does the exemption apply to a single operating unit comprised of contiguous parcels or would multiple exemptions be allowed? If exemptions are allowed on a per-parcel basis, would this drive requests for parcel splits? If multiple businesses are operating at a specific location (i.e., a high rise building on a downtown block) do all the businesses in the building get the exemption?
- Would separate legal entities with the same underlying owners get multiple exemptions?
- To obtain multiple $500,000 exemptions, would creative ways of holding high value personal property items using different legal entities become prevalent?
- Since only the first $500,000 is exempt, businesses would still file annual business property statements to detail and report their holdings. Thus, while the business personal property exemption it might eliminate the tax it doesn't eliminate the administrative burden for the taxpayer and the assessor.

Administrative Costs: Pending.

Revenue Impact:

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

SCA 5 operative dates are set three and four years forward. This estimate will not attempt to project growth rates in assessed values or future real estate market values. Nor will it attempt to predict future values of personal property. Rather, staff has estimated the revenue impact based on current data.

Business Personal Property: Exemption

In California, all property is taxable, unless exempted by the California Constitution or federal law. By statute, personal property may be classified for differential taxation or exemption. SCA 5 exempts from taxation the first $500,000 of personal property, including fixtures, used exclusively for business purposes, as defined. Staff estimates the 2014-15 assessed value of "business personal property" that would be exempt under this proposal at $94.3 billion. Revenue loss calculated at the basic 1% property tax rate is then $94.3 billion x 1%, or about $1 billion.

Commercial/Industrial Property: Annual Reassessment

The California Constitution generally limits ad valorem taxes on real property to one percent of the "full cash value." Full cash value means the assessed value as defined by the assessor's valuation on the

1975-76 tax bill, or upon the appraised value when purchased, newly constructed, or transferred thereafter. SCA 5 requires the full cash value of commercial and industrial property, as defined, be considered the fair market value as of the lien date.

Staff estimates there are 650,000 commercial/industrial properties in California. Based on our latest study of assessed values organized by property type, staff estimates 2014-15 assessed values of commercial/industrial property at $1.160 trillion.

Each year, the Board of Equalization (BOE) conducts a study to determine the effective assessment level (i.e., the percentage difference between assessed value and market value) for commercial/industrial property in order to determine the assessment level for rail transportation property (the 4R Ratio). The latest study, based on the 2013-14 assessment roll, finds the effective assessment level is about 74%.

However, this ratio is for the total value including real property (land and improvements) and other personal property. In an attempt to more accurately reflect the ratio on *real* commercial/industrial property only, staff adjusted the 4R ratio to exclude all locally assessed personal property and state-assessed property, and examined data over the previous twenty years. This resulted in an average effective assessment ratio of 70%.

SCA 5 provides for a phase-in of the reassessment of commercial/industrial properties. Beginning fiscal year 2018-19, half of all such properties that have either never been reassessed at fair market value after 1975-76, or have not been reassessed in recent years, would be reassessed to fair market value. In fiscal year 2019-20, all other remaining commercial/industrial properties would be brought to fair market value.

Analyzing multiple years of BOE commercial/industrial sales files obtained from county assessors, staff estimates the effective assessment ratio of the oldest fifty percent of properties, those likely included in the first phase of reassessment, at close to 54 percent. During the second phase of reassessment, staff estimates a ratio of about 72 percent. It is reasonable to expect a higher ratio for properties set for reassessment in 2019-20, as those properties will have assessed values more in line with present market values, likely having been reassessed at least once since the year 2000. However, as for calculating the impact on property tax revenue within each phase, due to such a wide range of values for various base years, in some cases spanning as long as forty years since the most recent base year value setting, making such a determination proves difficult.

SCA 5 does not take effect until 2018-19. Given the potential for assessed values and market values to be unpredictable during the next few years, we have estimated revenue gain using current data. Applying the above ratio to the estimated 2014-15 commercial/industrial assessed value, we estimate revenue gain as follows:

	Estimated	**Estimated**	**Estimated**	**Estimated**	**Estimated**
Assessment Year	Assessed Value Comm./Indust.	Average Assessment Ratio	Market Value Comm./Indust.	Increase In Assessed Value	**Annual Revenue Gain @ 1% Basic Property Tax Rate**
2014-15	$1.160 trillion	70%	$1.657 trillion	$497 billion	**$4.97 billion**

In cases where reassessment causes the value of a commercial/industrial property to increase above 25 percent from its previous value, SCA 5 provides for an exemption, for up to five years, on that portion of the assessed value over 25 percent, provided the following conditions are met:

1) the owner uses a majority of the property for their own business purpose; and,

2) the aggregate fair market value of all of the owner's properties statewide does not exceed $3 million.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.

Once expired, property owners would not be liable for taxes exempted during the exemption period.

Since it is likely the number of properties that would qualify for this exemption is small and cannot be easily determined, we did not estimate the revenue impact of this part of the proposal.

REVENUE SUMMARY. The business personal property exemption proposed in SCA 5 could result in a revenue loss of $1 billion annually. The proposal for annual reassessment of commercial/industrial property in SCA 5 could result in a revenue gain of more than $5 billion annually.

QUALIFYING REMARKS. This estimate does not attempt to project future commercial/industrial assessed values, or commercial/industrial market values. Calculations rely upon current values and do not intend to predict future revenue gain at the SCA 5 operative date.

Suggested reading: *Getting Real About Reform: Estimating Revenue Gains from Changes to California's System of Assessing Commercial Real Estate*, prepared by USC Dornsife Project for Environmental and Regional Equity.
http://dornsife.usc.edu/assets/sites/242/docs/Commercial_Property_Tax_Brief_PERE_web_updated2.pdf. The study projects an upward trend in assessed and market values resulting in a much higher estimated revenue gain than is calculated in our estimate.

The commercial/industrial assessment ratio calculation includes large multiple-family residential properties.

We did not determine the impact of SCA 5 in each county with regard to the Real Estate Deduction in Personal Income Tax Law and Corporation Tax Law.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.