

# Split Roll: Implications and Considerations

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## Introduction

As amended by Proposition 13 in 1978, the State Constitution requires, with few exceptions, that all categories of real property on the local assessment roll be assessed at the same time, at the same basic tax rate, and under the same valuation standard. Thus, whether real property is residential, commercial, industrial, or any other type, it is generally subject to Proposition 13's "acquisition value" system.

Under this system, property is taxed each year based on its market value as of the date of the most recent change in ownership. Once that initial "base year value" is established, subsequent increases in value are limited to a maximum 2 percent per year. The basic tax rate is limited to 1 percent of assessed value.

Most proposals for a *split roll* would alter the existing system so that one or more categories of non-residential property (e.g., commercial and industrial properties) on the local assessment roll would not be subject to the "acquisition value" system established by Proposition 13. This could take any of several forms.

For example, the Legislature could amend the definition of what constitutes a change in ownership so that commercial and industrial properties owned by corporations are reassessed at market value more frequently. As alternatives to reassessing non-residential properties more frequently, the tax rate or the allowable inflation adjustment applicable to non-residential properties could be increased. Finally, the Constitution could be amended to periodically appraise commercial and industrial properties at current market value. However, most recent "split roll" proposals have not focused on the type of property being taxed but rather on whether it is owned by an individual or by a legal entity.

## Background: The Proposition 13 Task Force

To help implement Proposition 13, the Assembly Revenue and Taxation Committee appointed a special Task Force—a broad based 35-member panel that included legislative and Board staff, county assessors, attorneys in the public and private sectors, and trade associations. 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 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".<sup>1</sup>

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<sup>1</sup> The Task Force findings are published in California State Assembly Publication 723, "Report of the Task Force on Property Tax Administration," January 22, 1979. A second report, "Implementation of Proposition 13, Volume 1, Property Tax Assessment," prepared by the Assembly Revenue and Taxation Committee, California State Assembly Publication 748, October 29, 1979, provides additional information on how changes in ownership would be determined under Proposition 13.

The separate entity 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. By contrast, the ultimate control theory would look through the legal entity to determine who held the ownership interests and, thus, who had "ultimate control" of the legal entity. Under this theory, real property owned by the legal entity would be reassessed only when a single holder of ownership interests gained control of the legal entity through the acquisition of a majority of those ownership interests.

The Task Force recommended that the separate entity theory be adopted for the following two reasons:

(a) The administrative and enforcement 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...it becomes 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, for example). Taxpayers can justifiably be expected to understand that a transfer of real property is a change in ownership and must be reported to the assessor.

(b) The ripple effects of ignoring the general separate entity laws of the state could not be predicted. The ultimate control theory threatened unknown disruptions of business organizations and practices. The separate entity approach avoids that pitfall by adopting the existing structure of corporate, partnership, etc., laws and building upon them.<sup>2</sup>

The change in ownership definitions related to ownership interests in legal entities initially placed in statute in 1979 were based on the separate entity theory as recommended by the Task Force. However, thereafter, subdivision (c) of Section 64 of the Revenue and Taxation Code was added to provide that a change in ownership occurs whenever there is a change in control by a transfer (or transfers) of more than 50 percent of the total ownership interests to a single person or entity.

The second Task Force report explained that this addition was made "out of a concern that, given the lower turnover rate of corporate property, mergers or other transfers of majority controlling ownership should result in a reappraisal of the corporation's property—an effort to maintain some parity with the increasing relative tax burden of residential property statewide, due to more rapid turnover of homes. It was also a trade-off for exempting transfers among 100% wholly-owned corporations."<sup>3</sup>

The Task Force was concerned that because commercial and industrial property changes ownership less frequently than residential property, a shift in tax burden to residential taxpayers could occur. The definitions originally proposed for legal entities (based on the separate entity theory) were chosen to mitigate administrative difficulties.

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<sup>2</sup> "Report of the Task Force on Property Tax Administration," January 22, 1979, pp. 46-47.

<sup>3</sup> "Implementation of Proposition 13, Volume I, P:roperty Tax Assessment," October 29, 1979, p. 27.

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:

...Such 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 other than change in ownership, the difficult and controversial policy issues in choosing between the 'ultimate control' approach or 'separate entity' approach, outlined previously, would be largely avoided. The Task Force commends the principle of such a change to the Legislature for additional study....<sup>4</sup>

## Past Proposals for a Split Roll

Over the past twenty years, there have been at least fifteen formal proposals for a split roll. Five of these proposals were put forth in 2005. No matter the date, none of the proposals made its way into law. Seven of the proposals were voter initiatives, but only one made it onto the ballot: In 1992 Proposition 167, which would have modified the change in ownership definitions related to legal entities, was defeated by a 3-2 margin.<sup>5</sup>

## Proponent Arguments

Proponents of a split roll usually argue that under Proposition 13 non-residential properties receive favorable treatment vis-à-vis residential properties. For example, the existing rules defining change in ownership for properties owned by corporations are often said to result in less frequent reassessments of non-residential properties. Specifically, since property owned by a corporation does not undergo a change in ownership so long as no one person or entity gains control of more than 50 percent of the shares in the corporation, its property may be reassessed infrequently. By contrast, residential properties are reassessed whenever they are sold.

Regardless of the arguments put forth by split roll proponents, the proposals usually arise during times when, they say, government funding is falling short of what is needed. Still, at least one proponent has argued that the system of taxing new development at current market value, while allowing owners of surrounding land to benefit from consequent increases in market value without having to bear any of the cost of new infrastructure, discourages new investment.<sup>6</sup>

## Opponent Arguments

Opponents of a split roll usually assert that it would take money out of the pockets of small business owners, who, they argue, might therefore be less able to invest in their businesses or hire new workers. Opponents argue that during recessionary periods in particular, a split roll would further hinder economic growth and job creation.

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<sup>4</sup> "Report of the Task Force on Property Tax Administration," January 22, 1979, p. 57.

<sup>5</sup> State Board of Equalization Staff Legislative Bill Analysis, AB 2461 (2008).

<sup>6</sup> "California Commercial Property Tax Study," California Tax Reform Association, April 2004.

Opponents have also cited administrative and compliance concerns, noting that legal entities could be burdened with additional record-keeping requirements as to the turnover of their ownership interests.<sup>7</sup> County assessors could also be burdened by an increased workload attributable to having to reassess non-residential properties more frequently. And finally, the more frequent reassessment of legal entities would undoubtedly cause a dramatic increase in the workload of county assessment appeal boards.

## Studies and Data

Projections of the fiscal impact of various split roll proposals have relied on data that is difficult to interpret. For example, data collected by the State Board of Equalization seem to support the notion that residential properties bear a greater share of the total property tax burden now as compared to thirty years ago.<sup>8</sup> But several factors may blunt that interpretation of the data.

First, the Board's figures exclude the value of residential properties that have not received the homeowners' exemption. Thus, homes that aren't the principal places of residences of their owners are not considered. Second, the figures do not prove that the cause of the growth in assessed value of residential properties is attributable solely to more frequent reassessments; other factors, including the appreciation in value of residential properties and the rate of increase in the sheer number of residential properties may be in play. A study conducted by the California Tax Reform Association claimed, however, to account for such factors, and found them insignificant.<sup>9</sup>

Additionally, a private sector study requested by a pro-business group concluded that a split roll would have several deleterious effects on the state's overall economy.<sup>10</sup> By contrast, a study by a professor of Economics at UC Davis concluded:<sup>11</sup>

*The increase in tax revenue that would be received from market value property taxation of commercial and industrial property will have only minor impacts on the cost of capital for new investment by commercial and industrial enterprises. Most of the additional revenue that will be collected will be from taxes on undervalued land holdings and will not distort investment incentives.*

Thus, although data has been studied in various ways, there is no consensus about what a split roll would bring, either in terms of revenue or in terms of economic impacts.

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<sup>7</sup> "'Splitting the Roll' – What are the Implications for Businesses and Tax Policy," *Real Estate Taxation*, 3rd quarter 2004, Volume 31, Issue 4, p. 180.

<sup>8</sup> State Board of Equalization Staff Legislative Bill Analysis, AB 2461 (2008).

<sup>9</sup> "System Failure: California's Loophole-Ridden Commercial Property Tax," California Tax Reform Association, May 2010.

<sup>10</sup> "The Economic Effects of California Adopting a Split Roll Property Tax," Jose Alberro and William G. Hamm, September 2008.

<sup>11</sup> "The Economic Aspects of a Split-Roll Property Tax," Steven M. Sheffrin, Professor of Economics, UC Davis, February 2009.