THE CALIFORNIA SCHOOLS AND LOCAL COMMUNITIES FUNDING ACT OF 2018

How to Raise Billions for Schools and Services by Reforming the Commercial Property Tax System

Policy Brief

Summary

The California Schools and Local Communities Funding Act of 2018 proposes a constitutional amendment to put before voters an improvement to the 1978 law, Proposition 13. It will periodically reassess commercial and industrial properties to full market value, while safeguarding homeowners, renters and agricultural land. It will provide tax relief to small businesses and full transparency for the public. It will raise approximately $11.4 billion in statewide revenues from reassessment for 2019-2020, if fully implemented. A large share of the new revenues, or over $4.5 billion, will support K-12 schools and community colleges, with the balance allocated to local government (cities, counties, special districts).

I. The Problem

The system for assessment of commercial and industrial property is loophole-ridden, harmful to sound land use, housing, and new investment, and negatively impacts revenue for cities, counties, and schools. Not even the largest beneficiaries of the system—wealthy property owners and large corporations—can provide a rationale for its continuation.

A. The Loophole-Ridden System
Property tax assessment under Proposition 13 is based on a "change of ownership", which locks in assessment at the purchase price (plus 2% per year), and limits the tax rate for all properties to 1%. Intended to help homeowners, change of ownership is easily avoided by corporations and wealthy investors because of the complex ways commercial and industrial property is legally held, and cannot be reformed without maintaining loopholes and inequities.

1. Publicly-Traded Corporations: Change of ownership fails to reassess publicly-traded corporations, whose stock turns over regularly, unless those companies are fully bought out. For example, Chevron, Intel and IBM own land still assessed at 1975 values while nearby land is assessed at 50 times the value or more.

2. Investor-owned Property: Complex ownership patterns allow for avoidance of reassessment in many ways, on everything from industrial parks, offices, shopping centers and hotels to parking lots and mini-malls. Real Estate Investment Trusts (REITs) allow Wall Street investors to buy and sell shares in large properties without reassessment. Limited liability companies (LLC's) and partnerships have changing ownership shares and members but easily avoid reassessment. Family trusts have passed down ownership of valuable land for generations, protecting low assessments for the last 40 years and indefinitely into the future. Land leases are often used to keep land taxes low even when new construction occurs.

B. Unfair to New Investment
The current system taxes new investment heavily while failing to tax windfalls, the opposite of good economics. It holds land off the market, inflating land prices, which is bad for housing affordability and new investment. It is anti-competitive, as new businesses have to pay higher property taxes than their competitors, even though they are charging the same prices for their rents, products and/or services. Newer investors pay taxes on inflated market values and substantial fees and mitigations, while older commercial property owners who benefit from infrastructure growth and rising markets continue to pay on the old, outdated property values.

C. Failed Fiscal Policy
Even with massive economic growth and a proliferation of new local taxes, tax revenue per capita for cities and counties has fallen from $790 per person to $640 since 1978, according to the Legislative Analyst's Office (LAO), generating fiscal stress on most local governments in the state. The property tax has shifted away from commercial/industrial to residential in virtually every county. Our infrastructure investment has declined because local governments cannot generate the revenue needed from the growth in land values.

D. Works Against "Smart Growth" Land Use
The system has negative impacts on land use and the environment. The LAO and academic research shows that the system promotes keeping urban land vacant. It increases speculation and sprawl, the opposite of "Smart Growth". It drives up land prices that make housing less affordable. Important approaches to climate change and livability—increased density and transit—are discouraged by the current failure to tax commercial land appropriately.

II. The Policy Solution

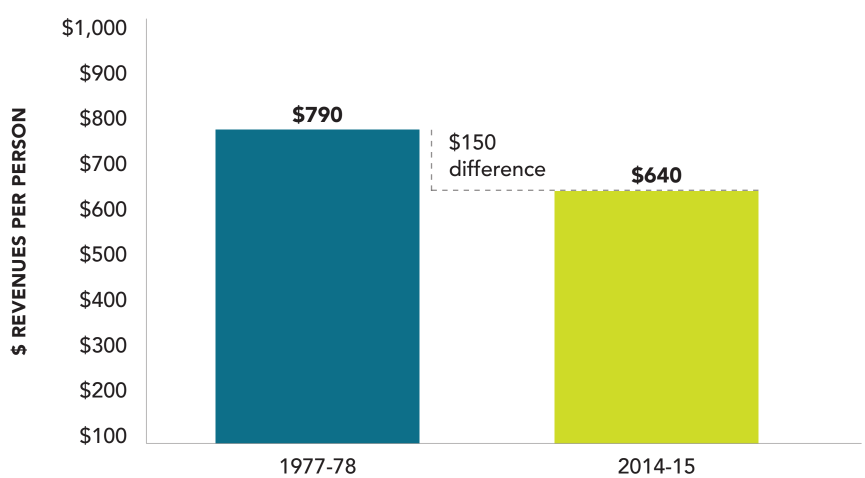
This policy proposal will require a constitutional amendment to be approved by California voters in order to reform the system for assessment of commercial and industrial property.

A. Reassessment
The core component of this proposal is the reassessment of commercial and industrial property to market value on a periodic basis, as occurs nearly everywhere else in the country. The current constitutionally mandated rate of 1% would remain unchanged.

B. Protecting Residential and Agricultural Property
Periodic reassessment will only affect commercial and industrial property, NOT residential and agricultural property. The measure defines such property through zoning categories in order to establish a "bright line". Properties zoned for agricultural purposes have long been protected by the Williamson Act, and are not to be reassessed. No residential properties will be reassessed, whether rental residential (apartments and rental homes), homeowner or condominium owner, or mobile home. To the extent that zoning categories are not sufficiently tight (e.g. residential hotels, nursing homes), the legislature is required to make certain by statute than no residential property will ever be affected. Mixed-use property is to be assessed based on proportion of commercial to residential footage.

C. Phasing In the New System
Since the system has not been changed in 40 years, a transition period will be necessary.
1. Assessor Provisions: The measure requires the legislature to provide for a "start-up" period, not less than two years, plus one year of lead time, to ensure a reasonable workload and implementation period for

Decline in Cities/Counties Per Person Revenues,
1977 to 2014



Legislative Analyst's Office. September 2016.
Common Claims about Proposition 13.
http://lao.ca.gov/reports/2016/3497/
common-claims-prop13-091916.pdf.

assessors. It then requires on-going assessment on a periodic basis, but no more than every three years, after initial reassessment is completed. There are many ways for the assessors to approach this work. For example, assessing the oldest properties and the largest properties first would generate substantial revenue while allowing smaller properties to be phased-in over a longer period. The timing is to be worked out by the legislature, in consultation with the assessors.

2. *Taxpayer Phase-In:* The phase-in process is also to be developed by the legislature. One possibility is a 3-year phase-in for the first properties to be reassessed, to ease in any increases in taxes, and 2-years for the more recent properties. The legislature will determine the appropriate phase-in period, but not less than two years.

D. Small Business Protections

1. Business Personal Property Tax Relief: The measure provides relief from the business personal property tax, eliminating it for all small businesses under 50 employees and providing an exemption of the first $500,000 for all other businesses. This exemption helps the vast majority of businesses that lease but do not own their property. It will take over 90% of businesses off the business personal property tax rolls, and provides relief from a nuisance tax as well as financial relief to small businesses.

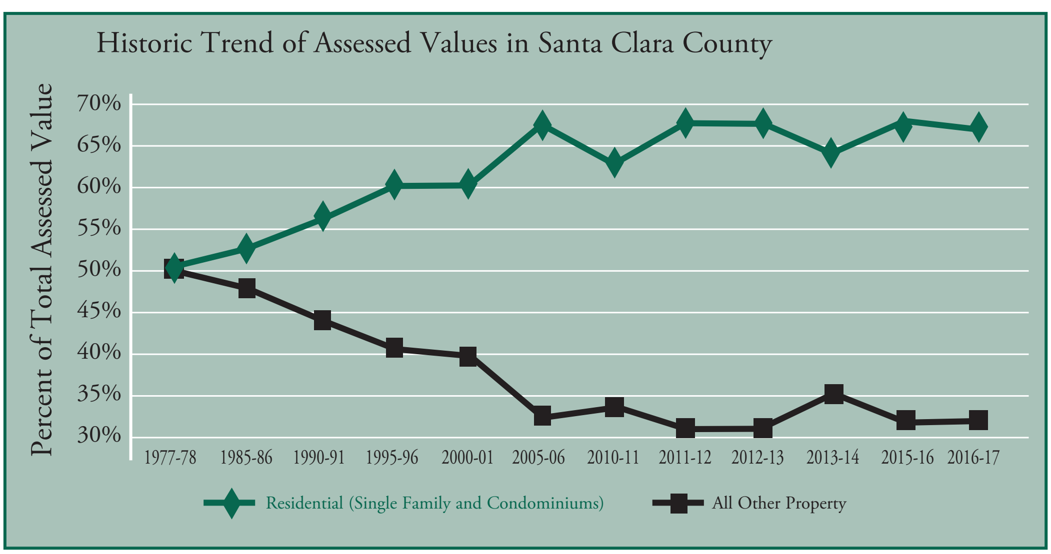
2. Small Owner-Operators: A very small number of smaller businesses own their properties and also run their businesses on it, most often in rural areas (e.g. motels, independent gas stations). Those businesses, with property value under $2 million, will be exempt from reassessment until they sell or no longer run their businesses on their property

E. Revenue Allocation

1. Local Government Share of Revenue: The proposal calls for revenue in each county to be allocated based on the current proportions of the property tax which go to the cities, counties, schools, and special districts. Except for the schools, the local jurisdictions in each county will receive the new revenue based on the share of the local property tax they currently receive. The measure leaves property tax allocation unchanged, because a combination of Proposition 13, (which puts property tax allocation in the hands of the legislature), and a subsequent constitutional measure (Prop 1A) control allocation.

2. School Share of Revenue: Because of the potentially great fiscal differences among school districts in richer vs. poorer areas, the school revenue generated in each county from the share of the property tax in each school district will be pooled statewide and protected for use solely by K-14 education. This incremental revenue will be over and above Prop. 98 formulas, so will not lower any state support for schools. To further address equity, it will be distributed based on the current Local Control Funding Formula or any successor formula provided by statute.

Property Tax Shift in 55 of 58 Counties



Office of the County Assessor. September 2016. 2016-2017 *Assessor's Annual Report.* https://www.sccassessor.org/edocman/AnnualReport2016_2017.pdf

F. Revenue Reimbursements
The state General Fund will be reimbursed against any losses resulting from an increase in commercial property tax deductions caused by reassessment, with the Franchise Tax Board to provide an estimate yearly. Assessors will be reimbursed from the new revenue for any increased costs of implementation. Revenue will be allocated to the newly-created school fund and to local districts after these reimbursements, which are a very small percentage of total revenue.

G. Accountability to Taxpayers
All school districts and local governments receiving revenue from the measure will be required to prepare reports to provide accountability to taxpayers for the use of the incremental revenue from collections. The legislature shall develop a consistent method to calculate the incremental revenues received.

III. Impacts

A. Projected Revenue
1. Statewide Revenue: Statewide revenue from reassessment is estimated at $11.4 billion annually, or between $10.8 and $12 billion statewide if it were to be fully implemented in 2019-2020. This is higher than the previously estimated $8-10 billion and is based on over 10 years of complete statewide commercial property data sets running from 2004-2016. This amount will grow with economic growth. The reform will generate $3.6 billion in Los Angeles County, $1 billion each in Santa Clara and Orange Counties, and produce substantial increases for all counties.

2. Schools: Schools will see over $4.5 billion in increased revenue yearly. This translates into between $15,000-$20,000 per classroom when fully implemented. Every school district will receive increased revenue, based on the Local Control Funding Formula applied statewide. All revenue will be in addition to and on top of current revenue guaranteed by Proposition 98.

Estimated Revenue Gains by County 2019-2020

COUNTY	ESTIMATED RANGE	MID-ESTIMATE
ALAMEDA	523.9 - 583.9	553.4
ALPINE	.2 - .2	0.2
AMADOR	2.4 - 2.9	2.7
BUTTE	15.0 - 17.5	16.3
CALAVERAS	2.3 - 2.7	2.5
COLUSA	4.0 - 4.4	4.2
CONTRA COSTA	329.5 - 366.7	347.8
DEL NORTE	1.4 - 1.6	1.5
EL DORADO	16.1 - 18.4	17.2
FRESNO	106.7 - 120.4	113.4
GLENN	3.2 - 3.5	3.3
HUMBOLDT	20.8 - 23.2	22.0
IMPERIAL	14.4 - 16.3	15.3
INYO	6.8 - 7.9	7.3
KERN	105.4 - 119.1	112.1
KINGS	15.6 - 17.6	16.6
LAKE	1.7 - 2.1	1.9
LASSEN	1.3 - 1.5	1.4
LOS ANGELES	3,443.8 - 3,826.9	3,632.2
MADERA	10.4 - 12.1	11.2
MARIN	67.1 - 75.1	71.0
MARIPOSA	1.9 - 2.2	2.1
MENDOCINO	25.8 - 29.0	27.4
MERCED	29.5 - 33.2	31.4
MODOC	.3 - .4	0.4
MONO	2.0 - 2.5	2.2
MONTEREY	61.9 - 70.6	66.2
NAPA	62.9 - 70.7	66.7
NEVADA	15.8 - 17.8	16.8

COUNTY	ESTIMATED RANGE	MID-ESTIMATE
PLACER	58.3 - 66.5	62.4
PLUMAS	3.8 - 4.3	4.1
RIVERSIDE	314.6 - 356.7	335.3
SACRAMENTO	134.2 - 155.5	144.7
SAN BENITO	5.8 - 6.5	6.2
SAN BERNARDINO	387.5 - 438.2	412.4
SAN DIEGO	800.1 - 898.4	848.4
SAN FRANCISCO	795.4 - 877.7	835.9
SAN JOAQUIN	84.0 - 96.1	90.0
SAN LUIS OBISPO	54.8 - 61.8	58.2
SAN MATEO	559.5 - 615.7	587.2
SANTA BARBARA	122.7 - 137.4	129.9
SANTA CLARA	1,011.4 - 1,121.3	1,065.5
SANTA CRUZ	43.5 - 48.7	46.1
SHASTA	18.6 - 21.3	19.9
SIERRA	.1 - .1	0.1
SISKIYOU	4.5 - 5.2	4.9
SOLANO	57.6 - 66.2	61.8
SONOMA	109.0 - 122.0	115.4
STANISLAUS	43.6 - 50.2	46.8
SUTTER	13.3 - 15.0	14.1
TEHAMA	6.3 - 7.0	6.6
TRINITY	1.4 - 1.6	1.5
TULARE	30.1 - 35.2	32.6
TUOLUMNE	5.6 - 6.4	6.0
VENTURA	163.0 - 183.2	172.9
YOLO	25.2 - 29.2	27.1
YUBA	7.1 - 7.9	7.5
Total	**10,778.8 - 12,031.3**	**11,394.7**

Program for Environmental and Regional Equity, University of Southern California Dornsife. May 2015. *Getting Real About Reform: Estimating Revenue Gains from Changes to California's System of Assessing Commercial Real Estate.* http://dornsife.usc.edu/pere/getting-real-about-reform/. Revenue estimates updated in June 2017.

3. Local Government: Cities, counties, and special districts will receive over $6 billion in increased revenues. Like all property taxes, revenues will be spent at local government discretion, for parks, libraries, public safety, capital outlay, health and social services, etc.

B. Who Pays?

1. Highest-Value Properties Pay the Most: The highest-value properties provide most of the revenue. 77% of the revenue comes from a small share of properties—that is, from properties estimated worth over $5 million, or 8% of commercial and industrial properties. These are mostly corporate-owned and wealthy investor-owned and have the lowest current assessment compared to market value. In contrast, nearly 75% of properties are worth under $1 million and generate only 5% of the total revenue.

2. Many Properties See Little Change: Many properties will see little or no impact. 46% of all commercial/industrial properties are within 30% of market value, with many of those close to or at market, and will pay little or no additional taxes as the measure phases in.

3. Oldest Properties Pay: Over 56% of the revenue comes from properties which were last reassessed before 2000. These include large corporate and investor-owned properties, many of which have not been reassessed since the 1970s and 1980s.

4. Most Value in Land, Not Buildings: Sixty percent of the revenue comes from the reassessment of land as compared to buildings and improvements. Buildings which are improved are currently reassessed while land may still be held at very old values. The differences in building values are nowhere near the disparities in land values, which can be as high as 100 to 1 in places where values have grown rapidly, such as Silicon Valley, San Francisco, and west Los Angeles.

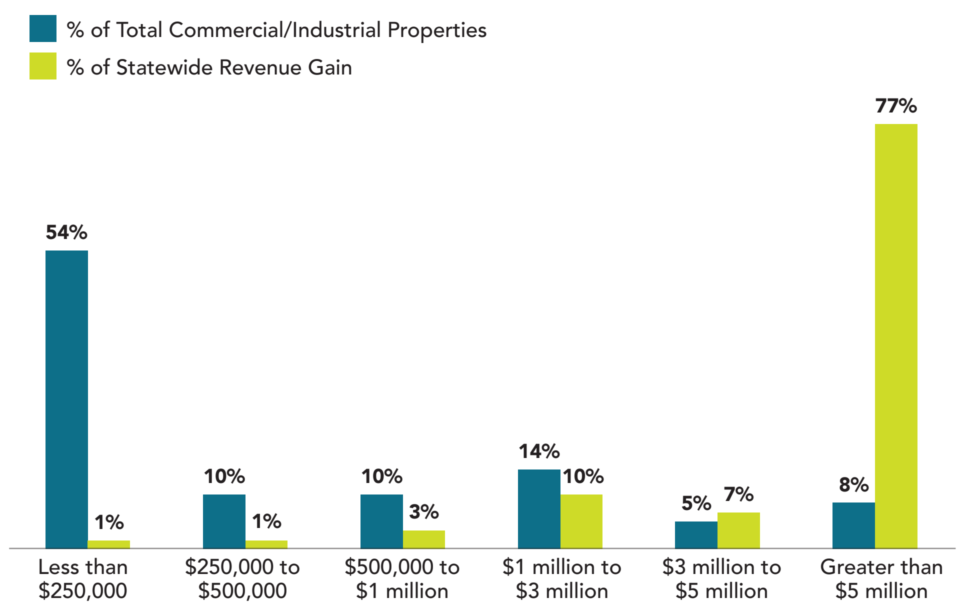
5. Out of State Investors: Substantial amounts of the new tax revenue will be paid by out-of-state and foreign investors and the very wealthy. Large properties are often owned by Real Estate Investment Trusts and are publicly-traded on national and international exchanges, and foreign investors have seen California commercial property as a safe long-term investment. Corporate shareholders are widely distributed nationally and internationally and would pay much of the property tax. Owners of commercial property are far wealthier than most citizens, generally within the top 1% of earners.

C. Broader Benefits and Impacts

1. Relief from Fees and Local Tax Pressures: Increasing revenue from commercial property taxes eliminates pressures for additional local taxes and fees, which have grown considerably as a portion of local government expenses. Over time, citizens and businesses have borne many of these new taxes and fees because large property owners have paid so little.

2. Infrastructure Benefits: Because rising land values will be captured, the ability to finance infrastructure is greatly improved, particularly for transit, where new investments can recover costs from rising land values.

Share of Total Number of Commercial/Industrial Properties and Share of Statewide Revenue Gain by Estimated Market Value, 2019



Source: USC PERE analysis of disparity ratios of commercial and industrial properties based on CoreLogic assessor roll data for 2016.

3. *"Smart Growth" Benefits:* Development which concentrates urban land use instead of promoting suburban sprawl and big-box retail will increase as underutilized, in-fill properties with high value but low assessments will be brought onto the market. Smart growth is a necessary part of combating climate change.

4. *Regulatory Climate Will Improve for Business:* The regulatory burden of fees and exactions put on new economic development will diminish, as cities have stronger fiscal incentives for new development and will be able to finance the costs of economic growth.

5. *Affordable Housing:* Local revenues from reassessment will enable cities to meet their local affordable housing obligations and address their homeless problems. The heavy fee burden on new housing development is likely to diminish. And the land use benefits will improve affordability for all types of housing.

6. *Small Business Benefits:* Every small business will benefit from the elimination of the business personal property tax. Opponents of reform cite the pressures on small business who have leases which would require pass-through of property taxes as rent increases. The fact is that commercial rents are at market and will not increase as a result of reassessment. Since many properties will face little or no increases, many businesses will have net benefits due to the elimination of the business personal property tax. A phase-in period allows small business the ability to adjust, including in their leases.

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