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INITIATIVE COORDINATOR
ATTORNEY GENERAL'S OFFICE

Hon. Xavier Becerra
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Becerra:

Pursuant to Elections Code Section 9005, we have reviewed the proposed constitutional initiative (A.G. File No 17-0055, Amendment No. 1) related to taxation of commercial property.

Background

Local Governments Levy Taxes on Property Owners. California local governments—cities, counties, schools, and special districts—levy property taxes on property owners based on the value of their property. Taxed properties include real property—land and buildings—and business personal property—machinery, computers, and office equipment. Property taxes raise nearly $60 billion annually for local governments, about $2 billion of which is attributable to business personal property. Statewide, about 60 percent of property tax revenues is allocated to cities, counties, and special districts, while the remaining 40 percent is allocated to schools and community colleges.

Property Taxes Are Based on a Property's Purchase Price. Each property owner's annual property tax bill is equal to the taxable value of their property—or assessed value—multiplied by their property tax rate. Property tax rates are capped at 1 percent plus smaller voter-approved rates to finance local infrastructure. A property's assessed value is based on its purchase price. In the year a property is purchased, it is taxed at its purchase price. Each year thereafter, the property's taxable value increases by 2 percent or the rate of inflation, whichever is lower. This process continues until the property is sold and again is taxed at its purchase price. In most years, the market value of most properties grows faster than 2 percent per year. As a result, under this system the taxable value of most properties is less than their market value.

Counties Administer the Property Tax. County assessors determine the taxable value of property, county tax collectors bill property owners, and county auditors distribute the revenue among local governments. Statewide, county spending for assessors' offices totals around $550 million each year. County costs for property tax collectors and auditors are unknown but much smaller.

California Taxes Individual Income and Corporate Profits. California levies a tax, known as the personal income tax (PIT), on the income of state residents, as well as the income of nonresidents derived from California sources. The PIT is the state's largest revenue source, raising around

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$83 billion in 2016-17. California also levies a tax, known as the corporation tax, on the profits of corporations. The corporation tax is the third largest state General Fund revenue source, raising around $10 billion in 2016-17.

Property Owners Can Deduct Property Tax Payments From Taxable Income. State law allows property owners to deduct property tax payments from their taxable income for the purposes of calculating PIT and corporation tax payments, effectively reducing their tax liability.

Proposition 98 Governs State Spending on Schools and Community Colleges. Earlier propositions passed by voters generally require the state to provide a minimum amount of annual funding for schools and community colleges, known as the "minimum guarantee." The minimum guarantee tends to grow with the economy and number of students.

Proposal

Assess Commercial and Industry Property at Market Value. The measure requires commercial and industrial properties, as well as vacant land not intended for housing or commercial agriculture, to be taxed based on their market value, as opposed to their purchase price. Properties owned and operated on by businesses whose property holdings in the state total less than $2 million (adjusted for inflation biannually beginning in 2023) are exempt from market value assessment. These properties would continue to be taxed based on purchase price. The measure's shift to market value assessment is phased in over a number of years beginning in 2020-21. The measure calls for the Legislature to establish the specifics of the phase in.

Exempt Lower Value Business Personal Property. The measure exempts from taxation the first $500,000 in value of a business's personal property. Additionally, the measure exempts from taxation all personal property of businesses with 50 or fewer full-time employees.

Allocate New Revenues to Local Governments and Schools. The measure allocates most new revenue resulting from the measure to cities, counties, special districts, and schools. Before allocating funds to local governments, the measure requires a portion of the new revenues be allocated to (1) the state General Fund to compensate for any reductions in PIT and corporation tax revenue resulting from the measure (as discussed below) and (2) counties to cover their costs of administering the measure. Of the remaining funds, roughly 60 percent is allocated to cities, counties, and special districts, with each entity receiving an amount proportional to the share of property tax revenues in their county that they receive under existing law. The remaining roughly 40 percent would be allocated to schools and community colleges according to the same per-pupil formulas the state uses to distribute most other funding for these entities. This allocation would supplement the existing funds schools and community colleges receive under the state's constitutional minimum funding requirement.

Fiscal Effect

Market Assessment Would Increase Property Tax Revenues. Upon full implementation, the measure's shift of most commercial and industrial properties to market value assessment would increase annual property taxes paid for these properties by $7 billion to $11 billion in most years. The amount of revenue raised in a given year would heavily depend on the strength of the state's real estate markets in that year. As a result, this new revenue stream would be considerably more volatile than property tax revenues have been historically.

Business Personal Property Exemption Would Decrease Property Tax Revenues. The measure's new business personal property exemptions likely would reduce property tax revenues by several hundred million dollars per year.

Allocation of Net Increase in Property Tax Revenues. On net, the measure would increase statewide property tax revenue by $6.5 billion to $10.5 billion annually in most years. From this revenue, the measure first allocates funding to cover:

- ***Decreased Income Tax Revenues.*** By increasing property tax payments for commercial and industrial properties, the measure would decrease taxable personal and corporate income and, in turn, decrease state PIT and corporation tax revenues. This decrease in PIT and corporation tax revenues could be as much as several hundred million dollars annually.
- ***Increased County Costs for Property Tax Administration.*** The measure creates significant new administrative responsibilities for counties, particularly county assessors. The new responsibilities could increase county property tax administration costs by a few hundred million dollars per year ongoing, with potentially higher costs in the early years of implementation.

Of the remaining $6 billion to $10 billion, roughly 60 percent would be allocated to cities, counties, and special districts, and roughly 40 percent to schools and community colleges.

Effects on the Economy. The measure could have indirect effects on the state's economy. For example, the measure would increase taxes paid by many businesses, thereby increasing their costs of operating in California relative to other states. This would influence some businesses' decisions about whether to expand in or move to California. Overall, the measure's effect on the health of the state's economy is uncertain.

Summary of Fiscal Effects.

- Net increase in annual property tax revenues of $6.5 billion to $10.5 billion in most years, depending on the strength of real estate markets. After paying for county administrative costs and backfilling state income tax losses related to the measure, the remaining $6 billion to $10 billion would be allocated to schools (40 percent) and other local governments (60 percent).

Sincerely,

Mac Taylor

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Legislative Analyst

for Ken Kroeberg

Michael Cohen
Director of Finance