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Taxing Commercial Property

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Assembly Revenue and Taxation Committee

Hon. Raul Bocanegra, Chair

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Overview of the Property Tax

- ***Major Revenue Source for Local Governments.*** Property taxes are collected at the county level and distributed to local governments—cities, counties, schools, community colleges, and special districts. Though property tax revenue does not leave the county in which it is collected, revenue that is allocated to schools and community colleges generally offsets state General Fund spending for K-14 programs.

- ***Annual 1 Percent Tax.*** The property tax is levied on the assessed value of real property (land and buildings) as well as personal property (primarily business equipment).

- ***Real Property Is Assessed at Acquisition Value, Increased by Up to 2 Percent Each Year.*** In general, properties are assessed to market value only when (1) a change-in-ownership occurs or (2) new construction takes place (only the improved portion of the property is reassessed following new construction). Otherwise, the value of the property grows each year by inflation up to 2 percent. As property values in California have typically grown faster than inflation, assessed values for most properties are much lower than their market values.

- ***Personal Property and State-Assessed Property Assessed at Market Value.*** Personal property and state-assessed property—primarily property that crosses county boundaries such as pipelines, flumes, and railroad tracks—are assessed each year at market value, adjusted for depreciation.

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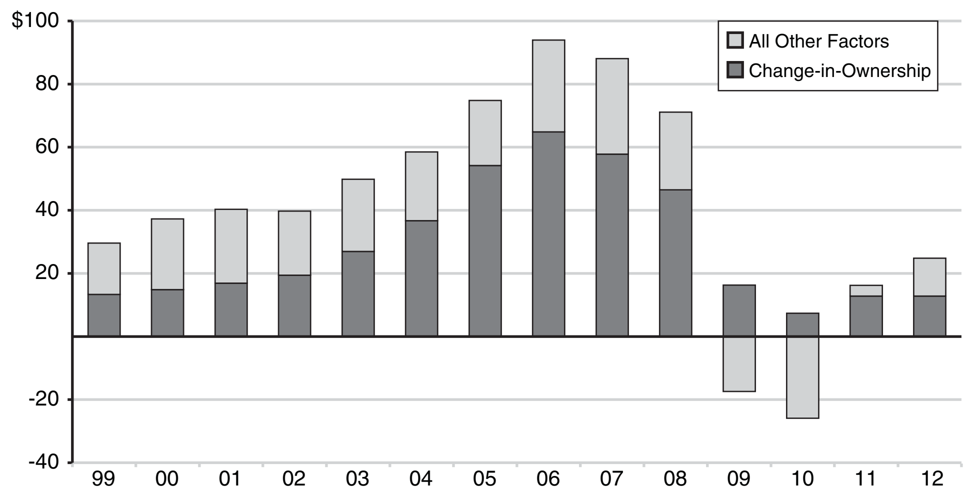
What Factors Affect Assessed Value Growth?

Components of Change in Assessed Value

Los Angeles County (In Billions)



All other factors include decline-in-value properties, the 2 percent inflation adjustment, and new construction.

☑ ***In Most Years, Change-in-Ownership Is Largest Component of Assessed Value Growth.*** Four main factors affect changes in assessed value each year: (1) the 2 percent inflation adjustment, (2) new construction, (3) decline-in-value properties, and (4) change-in-ownership. In most years, change-in-ownership accounts for the majority of the growth in assessed value.

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Proposition 13's Assessment Provisions

Assessed Value by Property Type

Property Type	2011-12 Assessed Value (In Billions)	Percent of Total
Single-Family Homes	$2,230	53%
Multi-Family and Other Residential	771	18
Commercial/Industrial	916	22
Agricultural and Other Non-Residential	256	6
Totals	**$4,173**	**100%**

- ☑ ***Acquisition Value Assessment Provides Certainty for Property Owners.*** Once a property is purchased, its owner knows that his or her property taxes will not grow faster than 2 percent annually.

- ☑ ***Acquisition Value Assessment Provides Revenue Stability for Local Governments.*** In any given year, only a small fraction of properties are sold and therefore reset to market value. This means that real estate conditions affect a relatively small portion of the tax base each year, largely insulating property tax revenue from year-to-year real estate fluctuations.

- ☑ ***For Homeowners, Acquisition Value Assessment Has Some Policy Merit.*** Among homeowners, the acquisition value assessment system encourages stable communities and ensures no sharp increases in taxes from year to year (of particular concern for homeowners with fixed incomes).

- ☑ ***Case for Commercial Properties More Problematic.*** Though these same benefits exist for commercial properties, 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 comparatively higher property taxes and therefore higher operating costs. This can discourage the formation of new businesses and reduce their profitability relative to other businesses.

Questions for Legislative Consideration

☑ ***Should the Legislature Redefine Commercial Change-in-Ownership?*** Commercial property transactions are complex. In some cases, two or more businesses may structure a property transaction so that the property transfer does not trigger reassessment to market value, even though the practical ownership of the property has changed. Typically, these transactions involve high-value commercial properties, for which avoiding reassessment significantly reduces the owner's tax liabilities. It is not clear, however, how frequently these types of property transfers occur or the amount of property taxes affected. If the Legislature wishes to reduce this occurrence by broadening the statutory definition of change-in-ownership, it should consider the following implementation issues:

- Given the complexity of commercial property transactions and the ability of commercial property owners to adapt to new tax laws, would modifying the definition of change-in-ownership effectively reduce transfers that escape reassessment?
- Would assessing commercial property at market value reduce the importance of identifying property transfers?

☑ ***Should Commercial Property Be Assessed at Market Value?*** Taxing commercial properties based on market value—sometimes referred to as a "split roll"—would treat all businesses similarly, regardless of the length of their property tenure. Implementing such a major policy change would require the Legislature to address a series of difficult questions, including:

- Should the tax rate on commercial property be reduced below 1 percent to maintain revenue neutrality? Alternatively, should the rate remain at 1 percent and thereby result in additional property tax revenue?

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Questions for Legislative Consideration

(Continued)

- What types of commercial property should be assessed at market value? Should apartment complexes, for example, be assessed at market value despite their being residential?
- How often should local governments reassess commercial property to market value—for example, once every three years on a rolling basis—and what additional resources would county assessors require for these assessments?
- How would this change affect revenue stability?