



PRESIDENT'S MESSAGE

October 2020

Many people in the property tax world will be aware that one of the “notorious” aspects of the property tax system in California is referred to as “Prop. 13”. In short, Prop. 13, passed in 1978, limits property tax rates to 1 percent (for both residential and commercial property) and limits the growth rate of future assessments to 2 percent per year. That means there are two types of property tax limitations: an assessment limit and a rate limit. The assessment limit is only removed when a property is sold in which case a new assessment is undertaken to value the property at its sale price. That can come as a shock to a purchaser who might see the property tax on their new home or business increase dramatically.

Depending on your perspective, Prop. 13 is either a necessary safeguard against rapidly increasing property taxes or a barrier to fairness which prevents the overall burden of property taxes being spread evenly across all the taxable properties in a jurisdiction. It certainly results in identical properties paying sometimes considerably different amounts of property tax.

The reason Prop. 13 is back in the news is that, in November, voters in California will have the opportunity to amend Prop. 13. The amendment would result in a “split roll” with the Prop. 13 limitations no longer applying to commercial properties. However, they will still apply to residential properties.

There has been lots of media coverage of the issues, not all of which provides a dispassionate view of the proposed amendment. One report I read recently did seem to try to put a relatively neutral perspective on the merits or otherwise of the position.

This report stated that, while Prop. 13 creates some perverse incentives, such as disincentivizing people with a favorable property assessment to move, it also prohibits split roll property taxation. Under current law, California cannot charge different rates for residential and commercial properties; it must tax all property at the same rate.

In addition, Prop. 13 “requires taxes raised by local governments for a designated or special purpose to be approved by two-thirds of the voters,” and all tax increases to be passed by two-thirds of both houses of the California legislature.

The new Proposition 15, as it is called, would keep the limitations in place for residential properties but repeal them for commercial and industrial properties.

Not only would this create a split roll, but California’s approach would be particularly aggressive, according to the report, because commercial property assessments would track market value while residential property would continue to have its value artificially suppressed, widening the gulf between the classes of property with each passing year.

The report points out that a “split roll” refers to the practice of applying a different tax formula, either tax rate or assessment ratio, to commercial properties than that applied to residential properties. For instance, it goes on to say, a state could levy a property tax of 2 percent on assessed value across all classes, but calculate assessed value differently depending on the class. To favor residential dwellings, a locality or state could classify assessed value on residential property as 10 percent of market value but as 20 percent of market value for commercial property. In this example, the levy on commercial real estate is effectively 100 percent higher on commercial real estate than on residential. This type of split roll is currently in place in 19 of states in the US. Another way of creating a split roll is by levying different rates based on property class; this is a practice used by 7 of the states in the US.

This differentiation, according to the report, makes the tax code less competitive, as uniformity in property taxation is highly desirable. Split roll taxation is non-neutral and economically inefficient and undermines business competitiveness. Property taxes constitute the single largest share of businesses’ state and total tax liability in the US, accounting for 38 percent of state and local business taxes.

The report also points out that, when business property tax rates are set independently of residential rates, they tend to be increased more frequently. In California, Proposition 15 would cause businesses to take on a greater share of overall property tax liability with almost every passing year.

On 3 November 2020, voters in California will decide on Proposition 15. The measure would require commercial property to be reassessed according to market value beginning in FY 2023 and every three years hereafter. Property used for both commercial and residential purposes will be reassessed proportional to its commercial use.

There are a number of exclusions in the proposition as well. First, property used for residential purposes and agriculture are not included. Neither is commercial property under single ownership with no more than \$3 million worth of property statewide. Second, the measure exempts up to \$500,000 of personal property from taxation as well as all tangible personal property of various small businesses.

If Proposition 15 becomes law, it would, according to California’s Legislative Analyst’s Office, increase taxes on commercial properties by between \$8 billion and \$12.5 billion by 2025. Proposition 15 includes provisions about how this new revenue should be allocated. Several hundred million per year would be allocated to the counties to conduct the new assessments. Sixty percent of the remaining funds would go to cities, counties, and special districts.

Importantly, not all jurisdictions are guaranteed increased revenue from the change. In fact, some may see a decline of revenue due to the built-in exemptions. The rest of the remaining revenue (40 percent) would be allocated to increase funding for schools and community colleges through the Local School and Community College Property Tax Fund.

Of the revenue allocated to the Local School and Community College Property Tax Fund, 11 percent will go to community colleges and 89 percent will go to local schools. Each school is to receive a minimum of \$100 (subject to annual adjustment) per full-time student.

The report points out that a tax increase of up to \$12.5 billion is a significant additional burden on businesses already struggling due to the coronavirus pandemic, particularly small businesses with low cash flow. While the small business exemptions in Proposition 15 afford some protections from increased taxes, many small businesses rent space. Their rent is likely to go up as the tax increase is passed on through rental costs.

The report goes on to say that, when developing tax policy, lawmakers often ignore the incidence of a tax, or who actually pays the tax. For Proposition 15, this effect could have an unfortunate result of passing the cost to small businesses or consumers. If small businesses are unable to pass costs on to consumers, they will need to absorb the tax increase and cut their costs. That could result in job losses, lower pay, or worse benefits. If they can pass it on, costs will go up for Californian consumers. Despite Proposition 15 being offered as a measure to raise taxes on businesses, much of the cost will be picked up by consumers through higher prices on goods and services.

Separate from the split roll, Proposition 15 also impacts other tax practices currently in place in California. One of these is a property tax exclusion for solar energy production. Since voters passed Proposition 7 in 1980, solar energy systems have not been included in the value of the property when installed. Solar energy currently accounts for more than 14 percent of in-state energy generation across nearly 750 solar power plants. If Proposition 15 becomes law, it would reverse this practice and make solar energy systems a taxable type of real property at the time of construction rather than on a change of ownership. Such a change would have significant cost implication for the solar industry and energy consumers in California. This is seemingly an unintended consequence as a Senator has introduced a bill to reclassify solar energy systems as personal property; this is a change that would exempt them from property taxes.

The report states that Prop. 13 has long secured a stable revenue stream in California, albeit one that “improperly” values many properties. Unfortunately, Proposition 15 introduces the downside of greater revenue volatility without the upside of accurate, neutral valuations since it skews property tax burdens disproportionately toward businesses. If Proposition 15 becomes law, property tax revenue will be more volatile as it will follow the value developments of the commercial real estate market.

The report concludes that California’s voter-initiated Prop. 13 is deeply flawed. Its intentions - limiting property tax growth - are good but its design yields highly unequal treatment of properties across the state. Unfortunately, Proposition 15 does not improve the overall structure of California’s property tax system; instead, it adds complexity while dramatically increasing commercial property taxes.

And finally, the report states that California already offers one of the least business-friendly tax environments in the country. Were voters to approve a split roll regime, they would be doubling down on that reputation and further harming businesses’ ability to grow and flourish.

It will be interesting to see what voters decide, particularly if they do not consider all the implications.

Back to IPTI world. We have been busier than ever during September with a number of online events and progress being made in respect of several interesting projects.

One of our most recent events was an online presentation organised by IPTI's Corporate Advisory Committee on "Recent Developments in Legislation, Policies and Case Law". Our main speaker was a very experienced lawyer - based in Detroit - who gave corporate representatives a very useful update on a number of current issues, including the impact of COVID-19.

Also, during September, we held another in our series of online workshops looking at different aspects of mass appraisal. This one involved the sales comparison approach and our three very experienced presenters took participants through a hands-on approach to model building from start to finish. As usual, this workshop was well received by participants who appreciated the knowledgeable and friendly style of our mass appraisal experts.

At the start of September, I was involved in a presentation at the IAAO's "virtual" annual conference which should have been held in Denver, Colorado. I was speaking on the topic of "Quality Assurance for Property Tax Valuations - International Experience" which, as the title suggests, drew on IPTI's experience of quality assurance systems in 16 different property tax jurisdictions around the world.

I was also due to be in Denver later in September for the latest annual property tax workshop run by the Council on State Taxation (COST) in conjunction with IPTI. This event also moved online and I was involved in two interesting sessions. The first was an "Update from Assessors" which involved assessors and appraisers from California and Texas talking about current property tax issues and answering questions posed online by participants. For the second session, I was a co-presenter with a US lawyer and we were talking about the topic of "Integrity with Property Taxes". This involved a variety of typical property tax appeal scenarios and invited the audience to vote online whether or not they considered the actions of the hypothetical parties to be ethical. It was a very interesting session and, I am pleased to say, most participants got the right answers to the questions we posed.

And, on the topic of ethics, I was invited to make another online presentation during September, this time to students at a UK university, on the topic of "The Importance of Professionalism". The students had all just completed their Masters' degrees and were embarking on careers in property, so it was timely to remind them about the ethical nature of the role of a modern valuation professional.

Also, in September, I was invited to chair an online event organised by the UK Property Managers Association (PMA) who had arranged a meeting for their members at which a number of officials from HM Treasury agreed to speak about various aspects of the current review of business rates (non-residential property tax in the UK). The PMA members were pleased with the openness of the discussion and the willingness of government officials to talk about the issues; it was a lively event.

We also held the first in a series of webinars we are delivering in partnership with the Institute of Municipal Assessors (IMA). This was on the subject of the cost approach and involved two very experienced and able presenters. We have an exciting programme of future IMA-IPTI webinars; details of these and other future events can be found on our website: www.ipti.org

Now, it's time for a quick look at what is making headlines concerning property taxes in selected jurisdictions and countries around the world.

In India, it is reported that property tax reforms are key for the country's post-COVID urban transformation. The poor collection of property tax, the biggest revenue source for urban local bodies in India, in the first months of year, has put city managers in difficulty. The unprecedented nature of expenses incurred on health service delivery to tackle the COVID pandemic has emphasised the need to put property tax reforms on the fast track. Property tax remains the only major revenue source in the municipal portfolio and it contributed about 60 percent to municipal tax revenue in India in 2017-18. It is said that property tax revenue accounted for only 0.15 percent share of the country's Gross Domestic Product (GDP). This is below the estimated revenue in OECD countries which is almost over 1 percent for taxes on immovable properties as a percentage of GDP. With over half the financial year gone, the recovery of property taxes has become grimmer. Cities across India are in a quandary over poor tax collection and the possibility of the pandemic condition making it worse. The Mumbai civic body hasn't been able to collect any revenue from property tax because of a pending decision of waiving taxes for all properties under 500 square feet in the city. Property tax accounts for 24 percent of the Mumbai city revenue and this decision is likely to set it back by over Rs 3,000 million. The decision is pending and taxes have still not been collected. Taking note of the situation, the Ministry of Housing and Urban Affairs (MOHUA) recently called a meeting of state governments to discuss reforms and provisions. The MOHUA meeting looked at several measures including increasing property tax coverage, integrating information, frequent re-evaluating of properties, cutting down on exemptions and concessions, sorting billing processes, simplifying payment gateways and making enforcement more stringent.

In Portugal, recent analysis has been looking at whether the tax authorities are doubling the assessed value of properties. The assessed value (Portuguese acronym: VPT) of buildings is determined in accordance with the Municipal Property Tax (IMI) Code's standard formula, which incorporates six criteria specifically designed to evaluate urban buildings: average cost of construction per square meter (Vc); surface area (A); occupancy coefficient (Ca); location coefficient (Cl); quality and comfort coefficient (Cq); and age coefficient (Cv). The Act provides a different formula to calculate the VPT of building plots: "the assessed value of building plots shall be the sum of the value of the buildable area, namely the area within the perimeter where the building will be built, measured by the outside part, and the value of the land adjacent to the buildable area". According to the law, the value of the buildable area could represent between 15% and 45% of the value of the licensed or planned buildings, after taking into account existing accesses, social facilities nearby, public transport offer, and whether the plot is considered prime property. As the location coefficient (Cl) in the standard VPT calculation formula varies in accordance with the exact same parameters, Portuguese higher courts have concluded that the standard VPT formula coefficients should not apply when calculating the VPT of building plots to prevent applying, by analogy, a formula specifically designed for buildings. The courts have therefore understood that the letter of the law does not allow applying - by analogy to the evaluation of building plots - an evaluation formula specifically designed for built property. This would actually breach the principle of legality, since the analogy is expressly prohibited in tax matters. Recent Portuguese case law has ruled out the application of the location coefficient (Cl) when calculating the VPT of building plots to prevent double taxation, as

this coefficient is already included in the calculation of the percentage used to determine the value of the buildable area. Using the location coefficient both in the calculation of the buildable area value and in the evaluation of the building plot would be tantamount to double taxation, as the same reality would influence the relevant VPT twice.

In the US, the Cook County assessor's office has announced the findings of a new study that verified conclusions reached by other researchers and investigators; the new study concluded that assessments in Cook County, Illinois are unfair. For the new study, researchers compared assessments of commercial buildings in Cook County to actual recent sales prices. They found that, in general, expensive properties are assessed at values lower than their true worth and lower value properties in the south suburbs and elsewhere are assessed at values greater than their actual worth. The study found that assessments deviated from actual market values by about 40% countywide, on average. In the city of Chicago, values were off by 50%, the report found. In the south suburbs, it was a little better, but assessed values still differed from market values by about 30%. The assessor said, "I'm not aware of anywhere in the United States where the numbers are this far off. The industry standard is to get it within 15%." Cook County reassesses properties every three years. Last year, properties in the north were reassessed. This year the focus is on townships in the south suburbs. Next year, it will be the city of Chicago's turn. It is reported that unfair assessments are one part of a complex system that has made some parts of the south suburbs look like a disaster has unfolded in slow motion. Some neighborhoods are characterized by vacant lots, fire-damaged structures and abandoned buildings. The area has some of the state's highest tax rates. Costs are high to provide services in Cook County compared to other parts of the state. There are fewer commercial properties in the south suburbs to shoulder the tax burden, so homeowners bear a greater share. Taxes have become so repressive throughout the region that owners of many commercial properties do not pay the real estate taxes that they owe. Tax collection rates in Harvey and other communities are below 60%, officials have said.

And finally, most readers will be aware of the controversy surrounding "The Wall" that is being built between the USA and Mexico. Leaving aside the politics, it may not be so widely known that there is a property tax aspect of this type of development that has come as an unpleasant shock to some taxpayers. It seems that land in South Texas - where a 3-mile stretch of private border wall was built earlier this year - has been valued at \$20.2 million which, in turn, has resulted in an estimated property tax bill of nearly half a million dollars. The taxes due went up dramatically from the 2019 valuation of \$272,000 for the property before the private wall was built. Additionally, the appraisal district reclassified the land from agricultural to commercial which increased the tax bill. A local official said, "I think it will help with future endeavors for people to understand that if they put up a structure like this, they'll be assessed taxes on it". And it may get worse as the cost of completing the private wall is reported likely to increase to over \$100 million which, in turn, will put up the property tax valuation and tax bill. There are various lawsuits going on both about the construction of the wall and the property tax bill that results from it. I imagine the owner is wishing he had built the wall a bit lower so the local assessor might not have spotted it!

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