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"Splitting the Roll" – What are the Implications for Businesses and Tax Policy

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Introduction

Property taxes exist in all states although exemptions, rates and the tax base vary from jurisdiction to jurisdiction. On average, 72.3% of local taxes collected are property taxes.[1] Thus, the property tax is a very crucial tax for local governments. Many states have limitations and sometimes, prohibitions, on local governments assessing income taxes. Thus, local governments often look to the sales tax and property tax when additional revenue is needed. The focus of this article is on what some states, most notably, California, have proposed over the past few years to increase property tax revenues. In particular, it will examine what are often referred to as "split roll" proposals because they propose to tax real property owned by businesses differently from that of homeowners.

Property Tax Basics

The property tax is an *ad valorem* tax based on a percentage of value of property. Real property is taxed by the jurisdiction in which the property is located (rather than where the owner resides). Jurisdictions often have different categories of real property. Typically, a function of the different categories is to enable different rules to be applied to each category. Such differences may be in tax rates, due dates, assessment procedures and assessment ratios. Common categories are residential, commercial and agricultural. Categories may be further broken down into public utility, mineral, and industrial.

An example of jurisdictions where categories of real property are taxed differently is Kansas where an assessment ratio of 11.5% applies to residential real property while commercial real property has an assessment ratio of 25%.[2] Assume a building has a value of $100,000. If it is residential real property, its taxable value is $11,500. If it is commercial real property, its taxable value is instead, $25,000. Thus, even if the tax rate is the same on all real property, the tax owed in Kansas depends on the type of real property.

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[1] Mandy Rafool, National Conference of State Legislators, *A Guide to Property Taxes: An Overview*, May 2002, page 12.

[2] *Ibid*, page 21.

Another categorical difference in applying property taxes to real property is that rates may differ among categories. Alternatively, exemptions might be different among categories of property. Most jurisdictions offer some type of homeowner or homestead exemption for owner-occupied residential property without a comparable exemption for non-residential property. Some jurisdictions offer economic development incentives or environmental exemptions to non-residential real property.

California's Real Property Tax System

Some states have similar property tax rules for all categories of property, but differences in property turnover rates, appreciation and usage lead to differences in property tax collections among categories of property over time. An example is California. The famous "Prop 13" ballot initiative passed by California voters in 1978 made constitutional changes for how property is valued and assessed. Under the "Prop 13 system," real property is valued based on the 1975-1976 valuation. If ownership of the property has changed since then, or property is constructed since then, the property is assessed at market value (typically the purchase price). Valuations may only increase annually at no more than the inflation rate or 2%, whichever is lower. The tax rate on all real property subject to Prop 13 is 1%.

The California real property valuation system is an acquisition-based one, rather than a market-based one. This system has created "dramatic disparities" between the property taxes assessed on properties that are similar, but purchased at different times. The California valuation system was upheld by the U.S. Supreme Court in 1992 under the equal protection clause of the 14th Amendment of the U.S. Constitution in a case involving residential property.[3]

Looking at changes in total property taxes collected on residential property versus commercial and industrial properties since Prop 13 took effect indicates that commercial and industrial properties contribute a lower percentage of total property tax revenue today than in 1975. For example, in 1975 in Los Angeles County, single-family residential property accounted for about 40% of the property tax roll while commercial and industrial property accounted for about 47% of the roll. In 2003, these percentages had changed to 55% and 32% respectively for Los Angeles County.[4] The rationale often offered to explain this change is that commercial and industrial properties do not change hands as frequently as residential properties and thus are not reassessed up to market value as frequently.

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[3] *Nordlinger v. Hahn*, 505 U.S. 1 (1992).

[4] Assessor Los Angeles County, *2003 Annual Report*, page 10; available at http://www.lacountyassessor.com/extranet/News/rollrls.pdf.

Los Angeles County also reports that for 2003, 20% of single-family residential property still had a 1975 base year value compared to 24% of commercial and industrial properties. The Los Angeles Assessor notes that despite over 5 million ownership changes since 1978 in a system with 2.3 million taxable parcels, 20% of the assessment roll has a 1975 base year value.[5] Thus, some properties have changed hands many times while 20% have not changed hands since 1978. Some people have argued that perhaps the public would be willing to repeal Proposition 13 since a small percentage of homeowners benefit from the 1975 base value.[6] However, in times when inflation exceeds 2%, even homeowners who purchased property in the prior year benefit from the "Prop 13 system."

Split Roll Proposals and Their Rationale

The underlying goal of split roll proposals is almost always to raise additional revenue from nonresidential real property. In some cases though, the proposal is offered as a tax cut where the tax reduction is not available to non-residential property. Examples of approaches to "splitting the roll" are explained next.

Reassess more frequently: In California, various proposals have been made over the years to reassess nonresidential property when cumulatively more than 50% of the ownership has been transferred.[7] This would be a significant change because today, if, for example, a corporation owning real property has a change in shareholders, that alone does not trigger a reassessment. A change in ownership would only occur if one person or legal entity acquired over 50% of the ownership interest in the legal entity. Another technique for more frequent reassessment of nonresidential property would be to do so on a "cycle that approximates the average of residential property turnover in the state."[8]

Reasons offered to support more frequent assessment of nonresidential property include bringing the assessed value closer to market value, to address concerns that homeowners bear a greater share of the property tax burden due to more frequent changes in ownership, to make the change in ownership rules similar for homeowners and businesses, and to acknowledge that the

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[5] *Ibid*, page 19.

[6] Los Angeles County has 25% of the statewide property tax base. Terri A. Sexton and Steven M. Sheffrin, "The Market Value of Commercial Real Property in Los Angeles County in 2002," report prepared for the Senate Office of Research, February 2003, page 3.

[7] See Proposition 167 (1992; not passed by voters), SB 1662 (2002) and AB 1013 (2001).

[8] California Commission on Tax Policy in the New Economy, Final Report, December 2003, page 29; available at http://www.library.ca.gov/CaTax/Docs/2003-12_FinalReport.pdf.

acquisition-based valuation system provides a competitive disadvantage (higher property taxes) for some new businesses – something homeowners don't experience.[9]

The California Board of Equalization analysis for California SB 1662 (2002) explains two theories on how to determine when property owned by a legal entity has changed hands, thereby resulting in a reassessment.[10] Under the ***separate entity theory***, the legal entity is treated as separate from its owners. As long as the entity owns the property, there is no change in ownership even if the entity owners change. In contrast, under the ***ultimate control theory***, one looks to who owns the entity. If a single holder gains control of the legal entity by acquiring a majority of the ownership interests, there is a change in ownership. California first adopted the separate entity theory and later changed it to a version of the ultimate control theory. The rationale for the change was to better match turnovers of nonresidential property with those of residential property.

Assess nonresidential property at market value rather than at an acquisition-based value: In California, an example of this is ACA 16 (2003) which would require nonresidential real property (with an exception for certain agricultural land) to be assessed at full market value at the lien date.

While the revenue potential of this type of proposal is obvious, additional reasons are typically offered. Some argue that compared to several decades ago, homeowners are paying a higher percentage of total property tax revenues and this inequity should be corrected by assessing business property at market value. Also, when businesses have vastly different property tax burdens for similar properties, there are competitive disadvantages to businesses that bought real property later in time. This type of competitive disadvantage does not exist for homeowners. Thus, there is less justification for an acquisition-based valuation system for business property. Of course, businesses don't vote and it is generally easier to raise taxes for businesses than for homeowners (despite the reality that all taxes are ultimately paid by individuals).

Subject nonresidential property to a higher tax rate: The tax treatment of nonresidential property may also be uncoupled from the system for taxing residential real property by applying a higher tax rate to nonresidential property. An example of such a proposal is one that may appear on the November 2004 California ballot to use most of the revenue raised from the

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[9] The competitive disadvantage for a new business under the Prop 13 system is varied because a new business may be leasing real property from an owner with a low-assessed value.

[10] State Board of Equalization Staff Legislative Bill Analysis for SB 1662, May 2002; available at http://www.boe.ca.gov/legdiv/ptleg/pdf/sb1662-2rkfinal.pdf.

increased property tax revenues to fund K-12 educational needs. The rationale underlying this type of proposal is the same as for assessing business property at market value (see above).

Provide tax relief only to residential property: An example of this type of proposal is SJR 8212 debated in the Washington legislature in 2000. This resolution called for a change to the constitution to remove the requirement for all real property in a district to be taxed uniformly. The resolution would have provided a $200 per year tax credit to homeowners, but not to owners of other properties. The $200 would have been indexed to increase at the rate of increases in personal incomes. The rationale underlying this type of proposal are the same as for assessing business property at market value (see above).

Pros and Cons of a Split Roll System

Of course, the advantages some legislators see in a split roll will be viewed as disadvantages for other legislators, depending on the goal they are trying to achieve with a split roll. The pros and cons of a split roll will be explained in terms of the views various stakeholders have with a split roll.

Most vocal about a split roll, are businesses. The foremost concern is the continual effects of having the taxation system for business property decoupled from that for residential property. Once two systems are created, it becomes easier to continue to change one and not the other. And, since businesses don't vote, they are concerned that some legislators will find new revenues by increasing property taxes on business property while leaving property taxes on residential property alone, or as was recently proposed in Washington, provide tax relief by decreasing taxes on residential property, but not on nonresidential property.

Other concerns that businesses have with a split roll relate to the associated increased taxes from the split roll proposal. Businesses note that higher property taxes will increase costs of goods and services and make the state an unfriendly place for businesses. Also, in poor economic times, businesses note that such a tax increase will prolong a recovery which will hurt workers, investors and customers. In addition, higher property taxes could reduce the value of commercial property which harms owners which includes pension funds. In Texas, where property tax reliance is high, businesses argue that increased dependence by the government on the tax is poor tax policy.[11]

Businesses also point out that there are administrative and compliance concerns with some split roll proposals. For example, additional time and recordkeeping are needed for a

[11] Business Law Section of The State Bar of Texas, Legislative and Political News Update of March 16, 2003; available at http://www.texasbusinesslaw.org/legupdate/FoodForThought.htm.

corporation to track when over 50% of its stock has changed hands thereby triggering a reassessment of the corporation's real property. There would also be additional work for assessors in tracking ownership changes and conducting more valuations, and more property tax appeals since valuation is not an exact science. An assessor's office may not be able to handle the additional workload and business properties tend to be more difficult to value than are residential properties.

Another argument against some of the split roll proposals is that often they do not call for all income-generating property to be subject to the new rules. Typically, residential rental property and some types of agricultural property are excluded, even though the business competition arguments in favor of a split roll would also generally apply to such income-generating properties.

In California, those that favor a split roll suggest that different rules are needed for nonresidential property because homeowner property warrants certain protections that businesses don't need or warrant. The Prop 13 system resulted in certainty in property taxes for homeowners. Such a system promotes neighborhood stability and protects homeowners from significant increases in property taxes on an annual basis.[12] Some argue that the same benefits are not warranted for businesses and that the acquisition-based valuation results in an "economic barrier to entry for new businesses. [Such a system] can discourage the formation of new businesses and reduce competition.[13]

As mentioned earlier, the data for Los Angeles County indicates that homeowners pay a larger percentage of property taxes today than they did a few decades ago. Thus, some argue that a split roll is needed in order for nonresidential property to contribute its "fair" share to the property tax system. As to how much might be raised in California by bringing non-residential property to market value, the answer is not clear. One study, based on data for Los Angeles County estimated that actual market value of commercial and industrial property in that county was $84 billion greater than its Prop 13 value (indicating potential additional property tax generation of $840 million annually in Los Angeles County alone (at a 1% tax rate)).[14] However, the Los Angeles County Assessor stated that an analysis done by his office indicated that the

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[12] *Ibid.*, page 6; and *Nordlinger v. Hahn*, 505 U.S. 1, 12 (1992).
[13] Legislative Analyst's Office, *Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes*, February 2000, page 6.
[14] Terri A. Sexton and Steven M. Sheffrin, "The Market Value of Commercial Real Property in Los Angeles County in 2002," commissioned by the California Policy Research Center for the Senate Office of Research, February 2003, page 3.

difference between the two values was only about $47 billion[15] (still a significant amount of revenue potential by moving from an acquisition-based value system to a market-based one).

Proponents of a ballot initiative in California to increase the tax rate for nonresidential properties justify the increase by arguing that business property produces income, fewer changes in ownership relative to homes results in a declining share of property taxes paid by businesses, California commercial property tax rates are among the lowest in the U.S., and small businesses can be protected by new exemptions.[16]

Tax Policy Analysis of a Split Roll

From the description and rationale described above for a split roll, it seems that the primary purpose is to raise revenue. Tax law changes focused purely on revenue often don't make for the best tax systems. In 2001, the Tax Division of the American Institute of Certified Public Accountants (AICPA) issued a tool to assist legislators and others in using principles of good tax policy to evaluate tax proposals.[17] The AICPA framework is applied here to a split roll proposal to assess nonresidential property in California using a market-based system rather than an acquisition-based one.

1. Equity and Fairness: Similarly situated taxpayers should be taxed similarly. Typically, "similarly situated" is evaluated using income because that is the pool of funds a person has to pay annual taxes. The value of real property though is not tied to the owner's wealth or annual income. This is well known in California where long-term homeowners may have seen the value of their home appreciate far beyond the annual increase in their income to the point where they could not afford to purchase their home today. That type of fact pattern helps to justify the acquisition-based valuation system. Does that fact pattern also justify an acquisition-based valuation system for businesses?

Similarly situated businesses might be viewed as those selling similar products in similar markets. Assuming the businesses face similar costs of materials and wages, if one company has a lower property tax liability, it has a competitive advantage assuming the companies have similar properties. The acquisition-based valuation system better satisfies the equity principle with respect to its application to homeowners than to businesses.

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[15] Press release of Rick Auerbach, Los Angeles County Assessor, February 25, 2003, "Estimates of Los Angeles County's Commercial Property Values Too High in Proposition 13-Related Study;" http://assessor.co.la.ca.us/.

[16] Filing of December 15, 2003 with the California Attorney General's Office for the Investing in Quality Classrooms Act.

[17] AICPA, *Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, 2001; available at http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf.

2. Certainty: The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined. Basically, this principle looks at the level of confidence that taxpayers have that they are calculating their tax liability correctly. Since valuation is not an exact science, the Prop 13 system that does not involve annual market valuations rates high on following the certainty principle. In contrast, a market-based valuation system has less certainty.

3. Convenience of Payment: A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer. A change in valuation method would not change the payment dates and thus, this principle is unchanged.

4. Economy in Collection: The costs to collect a tax should be kept to a minimum for both the government and taxpayers. The Prop 13 system keeps administrative costs low because property does not need to be valued annually. Instead, reassessments occur when there is a change in ownership and in such cases, valuations are usually not needed because the sales price is used. Annual valuations of nonresidential real property would pose a tremendous compliance burden on assessors and lead to increased appeal and litigation costs for some businesses.

5. Simplicity: The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner. The Prop 13 system with its cap on valuation increases is simple because few valuations are needed and owners can easily determine their property taxes owed on real property. A change to require annual valuations on nonresidential real property would be more complex than the present system and would likely lead to an increase personnel needed in the assessor's office and in increase in assessment appeals.

6. Neutrality: The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum. Many factors influence a property owner's decision as to whether and when to sell or buy real property. In California, the Prop 13 system is a factor that weighs in favor of not selling appreciated property and buying replacement value because doing so results in increased property taxes even though the new property may be almost identical to the prior property. A system of annual reassessment will remove (or at least reduce the impact of) taxes from a business owner's decision as to whether or not to replace real property.

7. Economic Growth and Efficiency: The tax system should not impede or reduce the productive capacity of the economy. The biggest concern expressed by businesses over a split roll where non-residential property will be taxed at a higher amount than residential property is

the adverse impact on businesses and the economy. While governments see the split roll as a revenue raiser (and perhaps to increase equity among businesses in the system), they are concerned about the risk that some businesses may not be able to afford a tremendous increase in their property tax bill, the state will appear to be unfriendly to businesses, and some businesses may leave the state.

As noted earlier, when revenue is the primary focus of a law change, principles of good tax policy may have been overlooked. Economic growth and efficiency is likely one of the overlooked principles. If this principle is considered, the jurisdiction might be able to both raise needed revenue and design a tax system that serves the economic goals for the jurisdiction. For example, if a jurisdiction was concerned about lack of business activity in particular areas, it could do what some jurisdictions, such some Pennsylvania jurisdictions, have done and tax commercial buildings at a lower rate than the rate applied to the land. To encourage commercial construction the property tax rate on buildings in certain areas could be lower than for land.[18] Basically, when a jurisdiction looks at both its revenue needs and what its economic development goals are, it might be able to be more efficient and successful than if it tries solely to raise revenue from what looks like an easy source.

A jurisdiction's efforts to use a tax system to attain a particular goal may seem counterproductive to meeting the neutrality principle discussed earlier. This is partly correct. However, any tax has economic implications. For example, in designing an income tax system, whether equipment is allowed to be depreciated over 5 years or 20 years results in a measure of income, but the choice will have an economic implication for taxpayers and the jurisdiction must coordinate the rule with the goals it has for economic development. Likewise, if a jurisdiction is looking for additional revenue, ensuring that the approach selected does not hinder its economic goals is important to good tax policy considerations.

8. Transparency and Visibility: Taxpayers should know that a tax exists and how and when it is imposed upon them and others. Under the proposed valuation system for nonresidential property, taxpayers would still be aware of the tax. Owners of nonresidential property would not necessarily know their property tax liability as easily as under the Prop 13 system, but the property tax would still be visible.

9. Minimum Tax Gap: A tax should be structured to minimize non-compliance. The existence of real property and its improvements is well documented and assessors would know

[18] For further information on these so-called "split-rate" systems, see David Brunori, *Local Tax Policy*, The Urban Institute Press, 2003, pages 134 – 138.

which properties to reassess under the change being evaluated. It is unlikely that the tax gap would be affected by the proposal.

10. Appropriate Government Revenues: The tax system should enable the government to determine how much tax revenue will likely be collected and when. Governments need some level of stability and predictability for their revenue streams. The Prop 13 system rates very high on meeting this standard because the inflation rate is known and basically, only property that has changed hands is reassessed with the new valuation based on the sales price. A change to value nonresidential property annually would make the system less predictable and stable. In good economic times, additional revenue would be raised, and in poor economic times, revenues would be reduced by some unknown amount. Of course, since the proposal only affects nonresidential property, there would continue to be some stability in the system for property taxes raised from residential properties.

Tax Policy Summary: A +/- scoring system is used where + indicates that the principle is satisfied and – means that it is not. If the proposal being analyzed would not change how a particular principle is met, it is scored with a "0." The proposal to value California nonresidential property annually based on market value results in the following:

Equity	+
Certainty	-
Convenience of Payment	0
Economy in Collection	-
Simplicity	-
Neutrality	+
Economic Growth	-
Transparency	0
Minimum Tax Gap	0
Appropriate Revenues	-

While the proposal to use a market-based assessment system for California nonresidential real property (rather than the Prop 13 acquisition-based system) scored more negatives than positives, the particular factors should be examined because each usually does not warrant an equal rating. For example, a proposal that scores a plus on simplicity, but a minus on equity may still be a worthwhile proposal if, for example, it prevents a complicated rule with limited revenue potential from applying to millions of taxpayers. In analyzing the split roll proposal, plusses in equity and neutrality are important in that they bring a greater degree of fairness to the tax system. However, minuses in certainty, economy in collection, simplicity, economic growth and appropriate government revenues arguably outweigh the plusses. The analysis is useful to help policymakers make improvements in the proposal. Can a modification be made that would still allow for greater certainty and simplicity, yet better achieve the economic needs of the jurisdictions that rely on the tax? And would the modifications not make the minuses worse or turn plusses to minuses? This may not be easy.

For example, one proposal is to increase the tax rate on nonresidential real property. This leaves the assessment system alone, which would remove the minuses on certainty, economy in collection, and simplicity. It would not, however, address the fairness principle because there would still be a competitive disadvantage to new businesses. Also, it would not help a jurisdiction to achieve its economic development goals. A variety of modifications could be examined including raising the inflation cap for nonresidential property, providing some type of relief for new businesses—perhaps if they invest in enterprise zones—or both.

Conclusion

With local jurisdictions in need of revenue and limitations on sources in many jurisdictions (for example, some states prohibit locals from assessing income taxes), and voters tending to prefer tax increases on business rather than on individuals, we are likely to see many states with split roll proposals. Such proposals have significant economic implications for state and local governments and economies. These proposals are best addressed by a broader discussion of the desired tax and economic policies and how best to achieve them.