25 Years After Proposition 13:

Exploring Reassessment of Commercial Properties Owned by Legal Entities

A Policy Analysis Conducted for the California Senate Office of Research,

by
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Executive Summary

Proposition 13, a state constitutional amendment approved by California voters as a citizens' initiative on June 6,1978, instituted an acquisition-based system for assessing California property taxes. This system protects owners from significantly rising property tax assessments even as their real estate value appreciates over time. Newly constructed properties, or those that change owners, are assessed at fair market value, but future assessment increases are capped at 2 percent. Under this system, new owners typically pay higher property taxes, at a base of 1 percent of market value, than previous owners paid.

Applying this change-in-ownership requirement to reassessments can be more complex when addressing businesses holdings. For example, it is possible for a legal entity such as a corporation or limited liability partnership (LLP) to own commercial real estate that continues under ownership of that legal entity although the legal entity's owners may change over time. After Proposition 13's passage, the Legislature determined that a change in ownership of a legal entity would be considered a change in ownership of the entity's real estate – thereby triggering a reassessment of that property – in two situations. First, a change in ownership takes place if the original owners of the legal entity cumulatively sell more than 50 percent of the entity's ownership shares. Second, a change in ownership occurs if any single individual or another legal entity acquires more than 50 percent ownership control of the entity.

Some critics argue that this method is flawed. First, they assert that the above definition for the change in ownership of legal entities provides a "loophole" that allows business ownership to change over time without ever triggering a reassessment. In particular, it is possible that a majority share of ownership of a legal entity can change without legally being considered a change in ownership, so long as no partner in the business individually acquires a majority share of ownership. Second, some believe that many business owners may be failing to report changes in ownership of their legal entities either purposefully to avoid reassessment or because of ignorance about what constitutes a change in ownership. Further, county assessors may fail to detect this non-reporting by business owners because there is no regular reporting requirement other than self-reporting by the owners. Third, to the degree that two above problems occur, local governments are receiving less property tax revenues than they otherwise would – revenues that would support local programs and services, including public schools. Fourth, proponents of commercial property-tax reform link the above problems to a trend, documented over the past decade, of homeowners paying a greater share of the state's total property tax burden relative to businesses. Finally, these critics argue that commercial reassessment problems result in greater disparities in the amount of property taxes paid by neighboring businesses, an inequity that creates a competitive disadvantage for new businesses.

The challenge lies in determining the existence and extent of such problems – and the degree to which they can be directly attributed to the definition and enforcement of change-in-ownership provisions of legal entities rather than to California's acquisition-based assessment system itself. In particular, it is difficult to estimate revenues lost from either loopholes or any non-reporting by owners. There is no reporting or tracking of minority changes in ownership of legal entities, and no one has conducted a study to estimate the level of property-tax evasion or non-reporting.

Even with these limitations, it is useful to consider the potential impact of various reform alternatives. Senate Bill 17 (Escutia), for instance, proposes several changes, the most significant of which would increase the monetary penalties for failure to accurately report changes in ownership of legal entities.

After exploring these issues, this paper offers a series of possible options for consideration by the Legislature. Legislative options to address "loopholes" could include:

- Basing a change in ownership on the cumulative transfer of minority interests,

- Lowering the acquisition transfer requirement to some amount below 50 percent, and/or

- Eliminating the proportional transfer.

Legislative options to reduce tax evasion could include:

- Requiring business to regularly report to the county assessor on whether or not they have undergone a change in ownership,

- Various steps to strengthen enforcement mechanisms, and/or

- Various steps to improve the reporting process.

Other options, such as a "split roll" that would tax commercial and residential property differently, would require a voter-approved constitutional amendment to Proposition 13.

The Legislature also could consider funding a study to estimate the frequency of tax evasion and non-reporting to determine if this is a significant problem. If so, perhaps periodic local assessors' audits would be cost-effective.

This paper is intended to explain issues and explore options in the reassessment of commercial properties owned by legal entities under laws adopted to implement Proposition 13 after its passage 25 years ago. Determining the best course of action is left to policymakers with the guidance of a new generation of California citizens.

Introduction

Imagine that you bought California business property in 1983 for $1 million. Now, after 20 years, it is time to retire and sell the business. You find a group of buyers who agree to a price of $5 million for your business property. Because of Proposition 13's limits on annual growth rates, your property tax payments in 2002 were approximately $15,000. However, your buyers will be facing a $50,000 property tax bill in 2003 when the property is reassessed at full market value on change of ownership.

Now, imagine that you are the same business owner, but your business property is owned by a legal entity (i.e. a partnership, limited liability company, etc.) of which you are the sole owner. Like many business owners, you own your property indirectly through a legal entity in order to protect your personal financial assets. You find the same group of buyers for your business, but now they buy the legal entity rather than the property directly. Under current California law, unless any one of the new buyers acquires a majority share of ownership in your business, the property will remain assessed at its 1983 base-year value. This means that your new buyers will continue to pay property taxes of about $15,000, with increases limited to 2 percent each year.

In recent years several state legislators and community organizations have attempted without success to revise commercial property-reassessment laws. Proponents of reform argue that the above and similar transactions are "loopholes" in tax law that unfairly benefit commercial taxpayers and disadvantage competitors while dampening local and state revenues.

This report briefly reviews the history of Proposition 13, setting the context for the significance of "change in ownership" in California property tax law. Second, the report discusses the definition of change in ownership in state law and its implementation in practice. Third, it examines problems associated with change-in-ownership law and implementation. The report next analyzes various alternatives for reforming property-tax law. Finally, this report recommends steps the Legislature could consider to address the reassessment system for commercial properties owned by legal entities.

Background

Pre-Proposition 13

Prior to the passage of Proposition 13 in 1978, California's local governments conducted the property-tax reassessment process differently than it is done today. At that time, each county assessor was responsible for regularly reassessing all properties in California for tax purposes. The assessor made this calculation by estimating the market value of the property, comparing it to the market values of other similar properties in similar neighborhoods and factoring in changes in overall housing and commercial property markets. Local governments and school boards set their own property-tax rates, and the resulting revenues were collected by counties and distributed among the county's cities, school districts, special districts and the county itself based on locally devised formulas.

David Doerr, a former legislative staffer employed by the business-oriented California Taxpayers Association, identifies several events and trends in the 1960s and 1970s that contributed to popular dissatisfaction with this system and eventually led to the creation and success of Proposition 13.[1] First, well-publicized examples of corruption in the assessors' offices of several counties came to light during the mid-1960s, prompting concerns among property taxpayers that property-tax assessments were unfairly administered.[2] Most significantly, though, the California housing market experienced rapid inflation in the mid-1970s, leading to rising home values and, subsequently, higher property taxes. For example, housing prices doubled in seven Southern California counties from October 1972 to October 1977, resulting in a doubling of property taxes paid.[3] In response, low-tax advocates argued that these rising taxes would force people, particularly those with fixed or low incomes, from their homes because they could not afford the new tax costs. While those in the Legislature and the Governor's Office were aware of these popular concerns, they were slow to respond with legislation to alleviate property tax burdens because of internal disagreement over the best course of action. Finally, by 1978 the state had a large budget surplus of over $5 billion.[4] The combination of the above events and trends provoked many Californians to believe that tax relief was both necessary and reasonable.

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[1] Doerr, David R. *California's Tax Machine: A History of Taxing and Spending in the Golden State.* Sacramento: California Taxpayers' Association, 2000, (130-3).
[2] Doerr, (72-76).
[3] Doerr, (131).
[4] California State Board of Equalization. "California Property Tax: An Overview." Sacramento, May 1999, (1).

Features of Proposition 13

After failing to gain enough signatures to put separate property-tax relief initiatives on the 1976 ballot, Howard Jarvis and Paul Gann joined forces and successfully collected 1.5 million signatures to put their property-tax reform initiative, contained in a proposed state constitutional amendment, before California voters in the June 1978 statewide election. Opposed by many in the state's political establishment in favor of a rival and more modest proposition placed on the ballot by the Legislature, Proposition 13 was approved by 65 percent of California voters. (See Appendix for the full text of the proposition.) Proposition 13 and the subsequent measures passed by the state Legislature to implement it contained several important features that have significant impacts on the property-tax system and revenues collected.

In sum, the Jarvis-Gann initiative ended the standard value-based property tax assessment system in favor of an acquisition-based property-tax assessment process. It did so in the following ways.

Limit on Property Tax Rates. Proposition 13 limits the property tax rate to a maximum of 1 percent of the assessed value of any residential or commercial property. Counties can tax properties at a rate lower than 1 percent but not any higher, with the exception of the rate required to finance voter-approved indebtedness.

Limit on Growth of Assessed Value. The Jarvis-Gann initiative also limits the annual taxable growth on assessed values to 2 percent or the rate of inflation, whichever is lower, unless there has been a change in ownership. This clause was designed to protect property owners from rapidly escalating prices. Thus when market prices grow faster than 2 percent in a given year, the growth in the taxable assessed value is capped at 2 percent above the previous year's assessed value. The Board of Equalization (BOE) is charged with determining the index of growth for the entire state. Since 1978, the growth rate has been less than 2 percent in only three years.[5]

Change in Ownership. After rolling back property values to 1975 levels, Proposition 13 also required that county assessors reassess properties at full market value only upon a change in ownership. Full market value is determined by the acquisition price for the property. Modifications or additions to existing property result in a new assessment for the modifications, but the existing property is not reassessed.

Establishment of Base Years. Every piece of California property has a designated base year determined by the year it was most recently purchased. (If it has not been sold since passage of Proposition 13, the base year is 1975.) The county assessor can determine the assessed value for any given year based on the last purchase price and base year, and the growth rates for each subsequent year.

Property Tax Allocation. The initiative further required that the distribution of property-tax revenues among local jurisdictions be allocated based on formulas set in state law. As previously mentioned, property-tax revenues had been allocated among

[5] Butler, Joel. Yolo County Assessor's Office. Personal interview. 14 Feb. 2003.

the cities, school districts, and special districts within each county according to locally made decisions.

Restriction of Future Tax Measures. Proposition 13 also restricted the ability of local governments to raise new taxes. The initiative required that new or increased local taxes for special purposes be approved by a two-thirds majority of local voters.

The Effects of Proposition 13

In the 25 years since its passage, Proposition 13 has had a monumental effect on California state and local government finances. Those impacts most relevant to the topic of this analysis are discussed here.

Lower Property Taxes for Property Owners. Proposition 13 was successful at achieving its principle aim, the reduction and stability of property-tax payments by California property owners. On average, California property owners pay a lower share of their income on property taxes than in the 1970s. Payments dropped significantly immediately following the passage of Proposition 13 in 1978. (See Table 1.)

TABLE 1: PROPERTY TAXES PAID PER $1,000 OF PERSONAL INCOME

Fiscal Year	Amount	National Rank	Fiscal Year	Amount	National Rank
1970-71	$67.45	3	1985-86	28.72	31
1971-72	71.09	4	1986-87	30.04	29
1972-73	70.21	2	1987-88	31.20	29
1973-74	62.84	6	1988-89	29.74	32
1974-75	62.71	5	1989-90	30.92	31
1975-76	64.13	6	1990-91	31.36	29
1976-77	65.14	4	1991-92	32.55	29
1977-78	63.57	5	1992-93	31.16	33
1978-79	30.37	35	1993-94	30.24	35
1979-80	28.41	33	1994-95	32.09	28
1980-81	27.84	35	1995-96	29.96	32
1981-82	28.86	31	1996-97	28.56	33
1982-83	28.10	34	1997-98	28.68	33
1983-84	29.58	30	1998-99	27.51	33
1984-85	29.86	29	1999-00	26.37	36

Source: California Department of Finance
www.dof.ca.gov

Property owners who hold their properties for long periods of time are insulated by the 2 percent cap from tax bills that reflect the more rapidly increasing prices in the housing market. Such differences are most strikingly illustrated when comparing neighboring homes or businesses of equal age, size, and condition that may have vastly different property-tax assessments because they were purchased at different times.

An analysis by the Los Angeles County Assessor's Office found that 27 percent (29,726) of its 111,827 commercial parcels have a 1975 base year.[6] Similarly, data from the Riverside County Assessor's Office shows that approximately 18 percent of its more than 20,000 commercial properties have base years between 1975 and 1979.[7] Properties with older base years typically have significantly lower property-tax bills than they would have if assessed on the basis of fair market value. For example, 1,110 commercial-industrial properties in Los Angeles County with a 1975 base year in 2002 underwent a change in ownership for an average reassessed value of $528,577,[8] compared with an average assessed value for the county's remaining 1975-base-year properties of $200,123 that year. In Riverside County, 18 percent of all commercial properties have 1970s base years. Because of their comparatively low tax bills, they account for less than 7 percent of the county's total assessed value of commercial properties.[9] (Properties that have been modified have multiple base years, reflecting assessments of their new construction.)

Using data from Los Angeles County, two economists, Terri Sexton of California State University, Sacramento, and Steven Sheffrin of UC Davis, estimated that the true market value of commercial and industrial properties is 57 percent higher than the actual assessed values in that county, for a total differential of $84 billion between market and assessed values.[10] The authors extrapolated from these findings to suggest that the amount of commercial-property taxes lost from holding assessed values below market values in the state is $3.35 billion. Using a more complete data set than Sexton and Sheffrin were able to acquire, the Los Angeles County Assessor's Office found the market-to-assessed-value differential to be closer to $47 billion, suggesting the total commercial tax differential for the state may be closer to $1.9 billion.[11] A 2002 study by the California Board of Equalization used a different methodology to estimate that the total property tax differential for commercial and industrial properties to be $2.4 billion.[12] These findings are significant because they suggest that California's local governments lose – and business taxpayers save – several billion dollars in commercial property-tax revenues each year due to the acquisition-based property tax assessment system.[13]

Changing Tax Burdens. Some analysts also have found that the current property tax-structure has changed the relative tax burdens faced by different groups of property owners. Specifically, since Proposition 13, homeowners have been paying a

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[6] Kinoshita, Dan. "Split Roll Analysis." LA County Assessor's Office. 2003.
[7] Data provided by Cathy Colt from Riverside County Assessor's Office.
[8] Kinoshita.
[9] Colt data.
[10] Sheffrin, Steven M. and Terri Sexton. "The Market Value of Commercial Real Property In Los Angeles County in 2002." Davis: Center for State and Local Taxation, 11 Dec 2002, (3).
[11] Auerbach, Rick. "Estimates of Los Angeles County's Commercial Property Values Too High in Proposition 13-Related Study." Press Release: Los Angeles County Assessor, 25 Feb 2003.
[12] California State Board of Equalization. "Staff Legislative Bill Analysis – SB 1662 (Peace)." Sacramento: 2002, (9).
[13] However, some economists argue that market prices are higher in California under Proposition 13 than would be the case under an *ad valorem* system because the benefits of Proposition 13 are capitalized into property prices (see O'Sullivan, Sexton, and Sheffrin). This suggests that elimination of Proposition 13 might not generate the full tax differential predicted by the above analysts.

growing share of the total property taxes collected in California, while the share paid by owners of commercial and industrial properties has been decreasing. (See Table 2.)

Table 2: Change in Relative Tax Burden for Homeowners

Year	Assessed Value of Homeowner Occupied Properties as % of All Assessed Value	Year	Assessed Value of Homeowner Occupied Properties as % of All Assessed Value
1979-1980	32.0	1991-1992	32.4
1980-1981	33.8	1992-1993	33.7
1981-1982	33.2	1993-1994	34.9
1982-1983	32.5	1994-1995	36.4
1983-1984	31.8	1995-1996	37.3
1984-1985	31.3	1996-1997	37.8
1985-1986	31.0	1997-1998	37.8
1986-1987	31.1	1998-1999	38.1
1987-1988	31.3	1999-2000	38.2
1988-1989	31.6	2000-2001	38.2
1989-1990	32.2	2001-2002	38.1
1990-1991	32.1		

Source: Terri Sexton. Center for State and Local Taxation, UC Davis. 12 March 2003.

Additionally, Proposition 13 has benefited those property owners who stay put, most often aging Californians who continue to own homes with early base years.[14] Not only is the cost of homeownership more expensive for new or more mobile buyers because of rising housing prices, but the dynamics of Proposition 13 mean that newer or more frequent homebuyers also tend to pay significantly higher tax bills than longtime owners.

Decline in Local Government Property Tax Revenues. Immediately after the implementation of Proposition 13, tax revenues dropped by 25 percent throughout the state. Since then, government tax revenues in California have increased steadily. Still, by 1995 they accounted for only 85 percent of pre-Proposition 13 revenues (adjusted for inflation) despite the addition of new construction throughout the state.[15] However, analysts have pointed out that the overall decline in tax revenues is a product of multiple factors, including not only the direct impact of Proposition 13, but also changes in the state's economy over the decades.[16] Analysts believe that the combination of these declining revenues and California's population explosion (particularly from foreign immigration) has created significant fiscal stress on local

[14] O'Sullivan, Arthur, Terri A. Sexton, and Steven M. Sheffrin. *Property Taxes and Tax Revolts: the Legacy of Proposition 13.* Cambridge: Cambridge University Press, 1995.

[15] Shires, Michael A. *Patterns in Government Revenues Since Proposition 13.* San Francisco: Public Policy Institute of California, 1999, (13).

[16] Shires, Michael A., John Ellwood, and Mary Sprague. *Has Proposition 13 Delivered? The Changing Tax Burden in California.* San Francisco: Public Policy Institute of California, 1998.

governments faced with greater demands for local programs and services but diminished capacity for meeting them.[17]

Local Government Reliance on Alternative Revenue Sources. Because Proposition 13 reduced tax revenues to local governments and limited their ability to raise new taxes, many of them became more reliant on alternative revenue sources. In particular, local jurisdictions – especially city governments – turned to various fees and service charges, including school impact fees on developers; benefit assessment districts; bonds; tax-increment financing; incorporations and annexations to expand tax bases; and voter-approved local sales tax increases for specific projects.[18]

[17] Baldassare, Mark. *When Government Fails: The Orange County Bankruptcy.* Berkeley: University of California Press, 1998.; Chapman, Jeffrey I. "The Continuing Redistribution of Fiscal Stress: The Long Run Consequences of Proposition 13." Lincoln Institute of Land Policy: Cambridge, 1998.

[18] California State Controller's Office. "Reassessing California's Tax Structure: Two Decades After Proposition 13." *Controller's Quarterly: California Economic Challenges.* Sacramento, Aug 1997, (5); Sexton, Terri A. and Steven M. Sheffrin. "Living with Limits: State and Local Finance in California." *Controller's Quarterly: California Economic Challenges.* Sacramento: California State Controller's Office, Aug 1997, (11-12).

Defining Change in Ownership

Change in Ownership of Real Property

As described previously, Proposition 13 stipulated that a change in ownership of property is required for a county assessor to reassess property at market value. Proposition 13 did not define "change in ownership." Instead, it was left to the Legislature to do so. Section 60 of the state's Revenue and Taxation Code[19] defines change in ownership as the following:

> *A "change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value which is substantially equal to the value of the fee interest.*

The application of this definition is rather straightforward when it is applied to change in ownership of real properties.[20] When an individual sells ownership interest and use of a property to another individual in exchange for a fair fee, then a change in ownership has occurred and the county assessor is authorized to reassess that property for taxation purposes. In addition, Section 61(c) of the Revenue and Taxation Code requires that if a portion of property ownership is sold, then only that portion sold may be reassessed for property tax purposes.

Change in Ownership of Legal Entities

The definition and application of change in ownership is more complex when dealing with properties owned by legal entities, such as corporations, limited liability partnerships (LLP), and partnerships. Similar to what already has been described, properties bought and sold by legal entities undergo a change in ownership and can be reassessed at full market value. However, a different set of issues arises in addressing the reassessment of properties when the legal entities themselves undergo a change in ownership. The owners of a business-owning California property can change, thereby also resulting in a new set of owners of the property itself.

Section 64 of the Revenue and Taxation Code further defines change in ownership as it applies to the transfer of interests of legal entities. Section 64(c) stipulates that a change in ownership occurs when any legal entity or person acquires more than 50

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[19] Appendix 4 contains key provisions of the Revenue and Taxation Code.
[20] Real property includes land and the improvements to that land, typically in the form of buildings and other structures.

percent ownership shares of a legal entity. In addition, Section 64(d) specifies that a change in ownership takes place when co-owners cumulatively sell more than 50 percent of their ownership interests.[21] In both of these circumstances, a change in ownership of the legal entity results in a change in ownership of the properties owned by those legal entities, thereby requiring a reassessment by the county assessor.

However, while changes in ownership of real property result in reassessments in proportion to the share of ownership change, a change in ownership of a legal entity results in a full reassessment of the properties owned by that legal entity. The justification for this is that the ultimate control of the property has changed hands whenever any single individual or entity acquires a majority of ownership. Therefore, the full amount of property owned by the legal entity is controlled by a new individual or entity. Table 3 summarizes some of the key similarities and differences between real property and legal entities regarding changes in ownership.

Table 3: Application of Change in Ownership Definitions

	Transfer of Real Property	**Change in Ownership of Legal Entity**
Maximum Property Tax Rate	1%	1%
Maximum Growth of Assessed Value	2% per year	2% per year
Definition of Change in ownership	When any portion of ownership interest in the property is transferred.	a) When co-owners *sell* cumulative of more than 50% of legal entity; or b) when any single interest *acquires* more than 50% interest of the legal entity.
Portion of Property That Is Reassessed	Portion that is transferred.	100% of property owned by legal entity.
How Change in Ownership is Identified	Deed filed with county recorder.	a) Self-reporting; b) business property statement; c) county investigation; d) deed filed with county recorder; or e) Legal Entity Ownership Program.

Identifying Change in Ownership

As already indicated, it is the responsibility of the assessor in each county to identify changes in ownership and reassess properties.[22] Identifying changes in ownership of real property is rather simple. Whenever an individual sells real property, he/she must file the deed of sale with the County Recorder's Office. The purchaser of the

[21] "Co-owners" refers to the original owners of the legal entity at the time ownership of the property was first transferred from an individual to the legal entity.
[22] The state Board of Equalization annually assesses properties owned by railway, telegraph, telephone, gas, and electricity companies.

property must also complete a Preliminary Change in Ownership Report[23] and the recorder passes this information directly to the assessor's office. Filing these forms is not only required by law, but is in the best interest of the parties engaged in the transaction. In most circumstances, any liabilities associated with the property following the change in ownership belong to the current owner. So the previous owner has a personal incentive to ensure that the deed is recorded correctly and in a timely fashion.

While many transactions of business ownership do not require filing a deed of sale with the county recorder, some transactions do involve a deed, which alerts the county assessor to a change in ownership. There are other ways for county assessors to learn of changes in ownership of legal entities. Sometimes owners voluntarily inform counties of the change. Additionally, county assessors annually send out a form[24] to all businesses that is designed to assess the value of business-owned personal property, but also includes requests for information about any change in ownership in the past year. County assessors can conduct investigations to determine changes in business ownership that they suspect have gone unreported. Anytime the county assessor's office suspects a change in ownership of a legal entity, it can require that the business supply ownership information to the assessor's office.

Additionally, the state Board of Equalization maintains the Legal Entity Ownership Program (LEOP). When business owners complete their income tax forms for the state, they must include whether or not their businesses have undergone a change in ownership in the past year. The Franchise Tax Board collects these tax forms and transfers a list of all businesses answering affirmatively to the LEOP. LEOP officials then send a Statement of Change in Control and Ownership of Legal Entities form[25] to each of these businesses. LEOP officials also may investigate businesses for change of ownership if they independently suspect one or upon a request from counties. However, well over 90 percent of LEOP cases are generated from the FTB list.[26]

Table 4: LEOP Investigations[27]

Tax Year	No. of Questionnaires	No. of Parcels	No. of Changes in Ownership
'99-'00	26,018	6,682	514
'00-'01	16,185	6,089	328
'01-'02	16,920	3,408	247

LEOP sends a monthly list to all counties of legal entities it determines have undergone a change in ownership. According to an internal audit, the efforts of LEOP officials to identify changes in ownership generated approximately $543 million in new property-tax revenues in the 1997-98 fiscal year.[28]

[23] Board of Equalization form BOE-502-A.
[24] BOE-571-L.
[25] BOE-100-B.
[26] Young, David. Legal Entities Ownership Program. Personal interview, 11 April 2003.
[27] *Ibid.*
[28] *Ibid.*

Problems Identified with Change in Ownership of Legal Entities

> *The task force recommendation notwithstanding, the general definition [of change in ownership of legal entities] has been engrafted with myriad exceptions and contradictions, creating a tangled web for the unwary and fertile ground for imaginative tax planning. The legislative scheme has confronted assessors with the task of analyzing complex business and real property transactions, a task for which they are ill-equipped by training and experience. The result is often confusion and uncertainty as well as conflict in interpretations in different counties.* -Kenneth Ehrman and Sean Flavin[29]

California Senator Martha Escutia, the California Tax Reform Association, and PICO California Project – a grassroots collection of churches and community groups – have together sponsored Senate Bill 17. This legislation is designed to correct perceived issues associated with the laws and reassessment process governing changes in ownership of legal entities.

These issues to include:

- "Loopholes" in tax law that allow changes in ownership over time without requiring reassessment of property;
- Shortcomings in reporting and enforcement requirements;
- Unequal tax burdens between homeowners and businesses;
- Tax inequities among businesses, and
- A diminished capacity of the tax system to generate revenue.

There is debate over the nature, source, and magnitude of each issue. They are explored separately below.

[29] Ehrman, Kenneth A. and Sean Flavin. *Taxing California Property, Third Edition.* Volume 1. Deerfield: Clark Boardman Callaghan, 1997, Chap. 2 – page 25.

Loopholes in Tax Law

As described previously, a change in ownership of a legal entity occurs upon acquisition of a majority share of a businesses ownership. This means that minority transfers of ownership (50 percent or less) do not trigger a reassessment no matter how often they occur unless a single buyer accumulates a majority share of ownership. Taking this to its logical conclusion, it is entirely possible that the full ownership rights of a business could be sold – even multiple times – and not be legally considered a change in ownership, as long as the ownership were divided between at least two interests, neither of which owned a share of control of more than 50 percent. As long as no single interest obtained a majority share of ownership, the properties owned by that legal entity would not be reassessed at full market value, maintaining the original base year and lower tax assessment.

In addition, Section 62(a) of the Revenue and Taxation Code permits what is referred to as proportional transfers. These transfers allow individuals or business entities to transfer title of ownership without triggering reassessment as long as the ultimate control of the ownership remains unchanged. For example, business owners might establish a limited liability company (LLC) and transfer ownership of the business from their names to the LLC in order to limit their legal and financial liabilities. As long as the owners own the LLC in the same proportion in which they owned the business originally, this proportional transfer does not result in a change in ownership for purposes of reassessment of the properties owned by the business. Similarly, if a corporation undergoes an internal reorganization so that it transfers a particular business enterprise from one subsidiary to another, no change in ownership is deemed to take place as long as the ownership control of the business remains unchanged after the transfer.

Proponents of SB 17 argue that the above transfers – both minority transfers of ownership and proportional transfers – should be considered when determining changes in ownership for property-tax purposes. They argue that these "loopholes" allow business ownership and control to be transferred without the properties owned by the business ever undergoing reassessment. These proponents further argue that it was never the intent of Proposition 13 to allow businesses to evade increases in property taxes indefinitely, as can occur under existing law.[30]

Alternatively, proponents of the current tax structure argue that the above are not loopholes at all but instead are reasonable rules given the complexity of assessing properties owned by legal entities in the context of the acquisition-based reassessment process established by Proposition 13.[31] Specifically, they argue that the fundamental consideration in determining business ownership should be who ultimately controls that business. For example, they argue that while it is true that minority transfers in ownership can result in a new set of business owners over time, there has not really been a change in control of the company if no single individual or entity has acquired majority ownership control. Additionally, these advocates argue that proportional transfers should be allowed so that reassessment considerations do not affect a

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[30] California Tax Reform Association. "The Commercial Property Tax: More Loophole Than Tax." Press release, 26 Feb 2003.
[31] Main, Fred. California Chamber of Commerce. Personal interview, 11 Apr 2003.

business' ability to reorganize its operations in ways that will allow it to operate more efficiently and effectively.

Unfortunately, state law does not require reporting of the minority changes in ownership. Therefore, no one is certain how often these smaller transfers in ownership occur nor of their value, were these properties to be reassessed. Similarly, we do not know if the frequency of these minority changes is dependent on various factors including ownership type, business size, business type, amount of property owned, location, or external market factors. Therefore it is extremely difficult to estimate the scope of this perceived issue.

Limitations of the Reporting and Enforcement Process

Proponents of SB 17 also point out that there are significant holes in requirements concerning reporting and enforcement of changes in ownership of legal entities. As indicated previously, majority changes in ownership are self-reported by the owner. If an owner fails to report a change in ownership of a legal entity – either because he/she is not aware of the requirement to report the change or because he/she prefers to avoid an assessment increase – the county assessor may never identify the change in ownership, and the property will remain assessed at its base-year value. This failure is much more likely to occur with changes in business ownership than with transfers of real property because there is no clear need or incentive for a business to report such a change, unlike reporting transfers of real property. Moreover, the fact that county assessors often find out about changes in ownership through indirect means (e.g. through the LEOP or by following local business news) suggests there is a real possibility that some number of businesses undergo a change in ownership without detection and without reassessment of their properties at full market value.

In addition, the penalties associated with failures to report changes in ownership might be considered too limited to effectively compel honest, accurate, and timely reporting. The fine for failure to submit a Preliminary Change in Ownership report with a deed of sale is $25. Failure to accurately complete or submit the Statement of Change in Control and Ownership of Legal Entities form[32] upon request from a county assessor is punishable by a fine of 10 percent of the taxes applicable to the new base year.[33] Additionally, the statute of limitations is eight years from the time of sale for county assessors to identify and assess changes in ownership, unless it can be proven that owners knowingly and purposefully neglected to report the changes.[34]

Appraisers from county assessors' offices suggest that the amount of revenue lost from this type of property-tax evasion is probably small, though none I have spoken with can provide a concrete number. Some assessors simply believe that the variety of mechanisms that counties have at their disposal to identify changes in ownership compel most business owners to report honestly and accurately in order to avoid tax penalties. In addition, staff at assessors' offices note that most changes in ownership

[32] BOE-100-B.
[33] Revenue and Taxation Code, Section 480.1.
[34] Lozza, Dan. Alameda County Assessor's Office. Personal interview, 3 Mar 2003.

of large businesses are easy to identify because many of those transactions receive media coverage in local newspapers and business journals.[35]

However, small businesses that own less than $400,000 worth of personal business property may find it relatively easy to avoid reassessment because they are not subjected to regular personal-property audits by the county assessor's office.[36] Although these audits are aimed principally at verifying the assessed value of business personal property, auditors also verify information regarding ownership of the businesses' real property. Auditors typically do not go so far as to investigate a change of ownership of any legal entity owning the business, though.[37] State Finance Director Steve Peace has argued that it is really the large corporations – not the small, individually owned businesses – that understand how to take advantage of such tax loopholes to avoid legal changes in ownership and thus escape reassessment.[38]

Unfortunately, no one has conducted a study or analysis to estimate the proportion of legal entity owners who actually fail to report or misreport changes in ownership. Los Angeles County data shows that 5.3 percent of commercial parcels underwent a change in ownership in 2002.[39] This might be extrapolated to hypothetically surmise that if only half of California business owners reported change in ownership honestly, the lost tax revenues from tax evasion would be between $100 to $180 million annually statewide, building cumulatively.[40] This estimate provides a reasonable upper-bound estimate of how much commercial property tax revenue is lost from tax evasion. While we cannot be sure, it is reasonable to expect that there would higher rates of evasion of reporting changes in ownership than corporate income taxes, for example. The federal income tax reporting system has regular reporting requirements of all businesses and more stringent enforcement measures. For the purpose of comparison, the IRS assumed a 15 percent noncompliance rate for corporate income tax reporting in a study done of income tax compliance between 1972 and 1992.[41] If California commercial and industrial property owners failed to report only 15 percent of changes in ownership, the amount of tax revenues lost would only be between $17 and $31 million each year.[42]

Diminished Property Tax Revenues

[35] Butler; Colt, Cathy. Riverside County Assessor's Office. Personal interview, 24 Feb 2003.; Kelleher, Kathleen. Sacramento County Assessor's Office. Personal interview, 14 Feb 2003.
[36] Colt; Lozza.
[37] Butler, Joel. Yolo County Assessor's Office. Electronic correspondence, 30 Apr 2003.; Ginsborg, David. Santa Clara Assessor's Office. Personal interview, 5 May 2003.
[38] "Senator Peace: Cure Prop. 13 'Sickness' by Reassessing Commercial Property, Boosting the Homeowners' Exemption and Cutting the Sales Tax." *Cal-Tax Digest* Feb 2000: 5-9.
[39] 8,018 out of 150,025 parcels (5.3%) worth $6.5 billion out of $123.5 billion (5.3%) of 2001 roll value underwent change in ownership as identified by the Los Angeles County Assessor's Office.
[40] Calculated by multiplying 5.3% by $1.9 billion and $3.4 billion.
[41] Department of the Treasury. "Income Tax Compliance Research: Supporting Appendices to Publication 7285." Internal Revenue Service: Washington, D.C., July 1988, (F-6).
[42] If 5.3% of changes in ownership represent 85% of actual changes in ownership, then in actuality 6.2% of businesses change ownership, leaving 0.9% that fail to report. This figure is then multiplied by the differential values of $1.9 and $3.4 billion.

To the degree that the previous two problems exist, less property tax revenues are generated from commercial properties to ultimately help fund local governments and public schools. In a February press release promoting her SB 17, Senator Escutia argued that state and county governments "are losing billions of dollars through loopholes in our corporate property tax code that we need now more than ever for our schools and local communities."[43]

As indicated earlier in this report, total property tax revenues are lower in real dollars than before Proposition 13, and by different estimates the difference between assessed values and market values of commercial and industrial properties is between $1.9 billion and $3.4 billion. While some of this lost revenue may be attributable to "loopholes" in tax law and insufficient reporting procedures, most is likely the result of the basic structure of Proposition 13's acquisition-based property system, described earlier in this paper. Identifying the full amount of property-tax revenue lost to "loopholes" and the reporting system is made especially difficult because no studies exist that have attempted to estimate frequency of minority changes in ownership or the amount of purposeful or inadvertent tax evasion.

Unequal Tax Burdens of Homeowners and Businesses

One of the key concerns expressed by proponents of SB 17 is that the total share of the property tax paid in California by homeowners has increased in recent years while the share paid by businesses has declined. Senator Escutia and the California Tax Reform Association believe that this change has occurred in part because of the "loopholes" in tax law that allow businesses to maintain older base years and lower property-tax payments despite actual changes in ownership over time. Meanwhile, homeowners who cannot take advantage of such "loopholes" are forced to pay the full costs associated with reassessment after a change in ownership. The result of this trend is that homeowners as a group must bear a larger burden of financing local services that benefit both homeowners and businesses. The California Tax Reform Association writes:

> *The single biggest hole in the state's tax system is the method of assessment of non-residential property. The burden of the property tax has shifted way from commercial-industrial property and towards residential – even, for example, in Santa Clara County through the heart of the high-tech boom…corporations change ownership constantly, yet the underlying assessment stays the same. Thus land values are often at 1975 values despite many changes in ownership. The loopholes for manipulating the system are endless.*[44]

As Table 2 demonstrates, homeowners have paid a higher percentage of the property tax burden since 1979. However, much of that change, from 32 percent to 38 percent, has occurred since the early to mid-1990s. This suggests that businesses aren't simply taking advantage of older base years with steadily declining property-tax

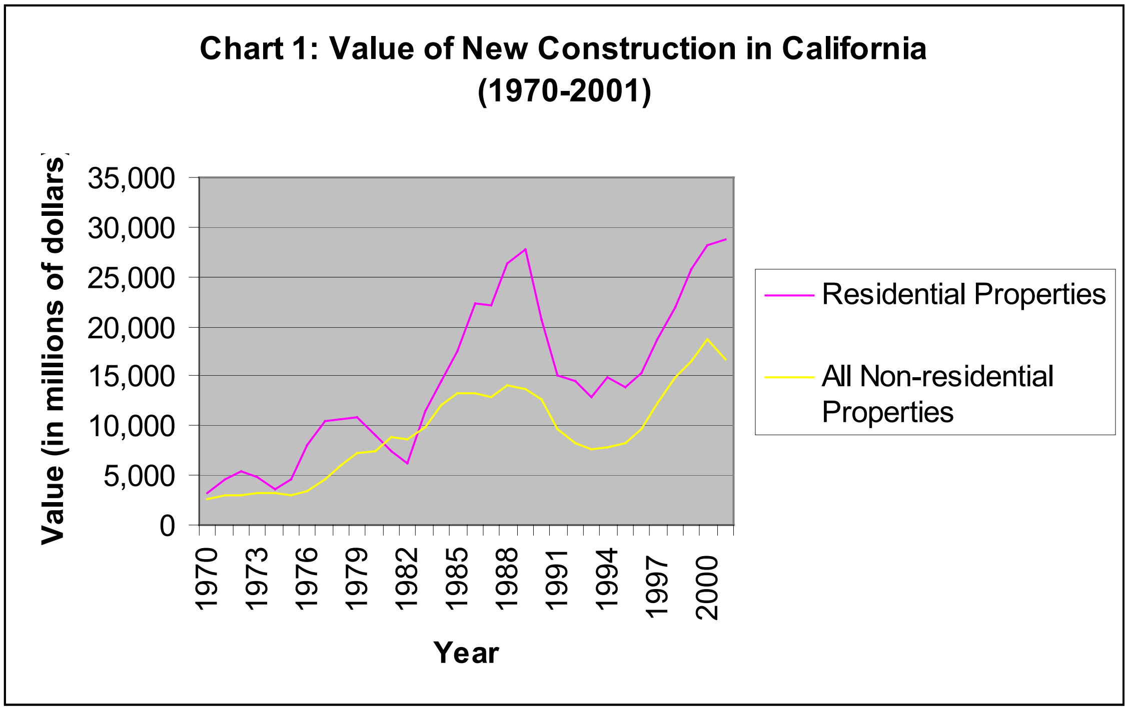
[43] Escutia, Senator Martha. "Senator Escutia and 100 Community Leaders Announce New Effort to Close Corporate Tax Loopholes, Raise Revenues for Schools and Local Government." Press Release: Sacramento, 26 Feb 2003.
[44] California Tax Reform Association. "Recommendations on Tax Policy." California Working Families Policy Summit. 24 Jan 2003.

assessments relative to homeowners over time. Instead, it should be considered that the causes of these changing tax burdens are more complex and most likely influenced by other factors.

In fact, Terri Sexton and Steve Sheffrin found in their studies of Los Angeles County's commercial and industrial properties that there was a significant decline in the proportion of these properties maintaining 1975 base years between 1991 and 2001. That proportion declined from 36 percent in 1991 to 29 percent in 1996 to 18 percent in 2001.[45] These findings suggest a significant turnover of buildings with older base years. Meanwhile, the proportion of Los Angeles homes with 1975 base years also declined from 1991 to 1996 (the authors' 2001 data did not include homes). The turnover rate was higher for homes than for commercial properties in both years. Specifically, 44 percent of Los Angeles homes had 1975 base years in 1991, with this proportion falling to 35 percent in 1996.[46]

It is important to understand that at least two other factors affect the property-tax burden faced by homeowners that are unrelated to change in ownership. First, while the burden faced by homeowners has increased, the burden paid by businesses has not decreased by the same amount. This is because the rest of the property-tax burden includes all agricultural, undeveloped, and residential rental properties. Second, changes in the relative tax burdens of homeowner and business properties could reflect differences in rates of new construction, value of developed land, and market prices for homes versus business properties. For example, Chart 1 shows that the value of new construction of residential units (including multi-family units) has grown faster than that of non-residential units. A question that remains unanswered is what is the "right" share of the property-tax burden that should be paid by homeowners and businesses?

[45] Sexton and Sheffrin. "The Market Value," (6).
[46] Sheffrin and Sexton. *Proposition 13.* (64-5, 72-3).

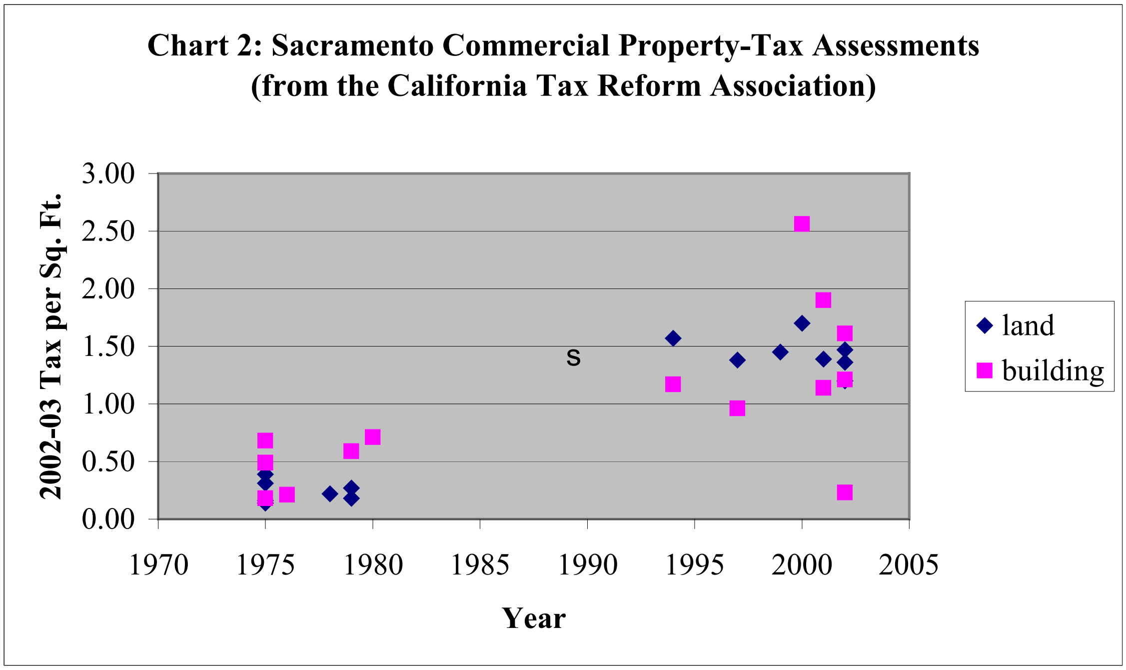


Source: Department of Finance. www.dof.ca.gov

Tax Disparities Among Businesses

Additionally, proponents of SB 17 have argued that the "loopholes" in change-in-ownership law are inequitable because they promote tax disparities among similar businesses. As an example, the California Tax Reform Association has noted the large assessment differences among several Sacramento hotels and commercial buildings. Chart 2 is a simplified reproduction of this data. It is clear that some properties have very different tax assessments per square foot of land and building, dependent largely on the base year. Land with older base years is taxed at a rate as little as $0.14 per square foot, while land with more recent base years is taxed as high as $1.70. Taxes paid on the buildings themselves vary even more, from $0.18 to $2.56 per square foot.[47]

[47] From "Downtown Sacramento Commercial Property Tax Study" handout at a news conference held by Senator Escutia on 26 February 2003.



It is unclear whether such tax discrepancies can be linked to loopholes in property-tax law, nor is it known to what degree they may hinder the startup of new enterprises. The California Tax Reform Association argues that such discrepancies put some business-property owners at a competitive disadvantage.[48] The California Chamber of Commerce counters that, while new owners may face initial tax disadvantages, they know that with time their properties will become older concerns with older base years and lower relative tax burdens, since Proposition 13 provides a "seniority privilege" for established commercial properties.[49] Moreover, the Chamber asserts, Proposition 13's protections provide a stable tax structure for business owners.

The most serious challenge to the application of Proposition 13 to business properties asserted that it gave an unfair competitive advantage to stores with older base years. After Contra Costa County determined during the 1980s that a corporate buyout of Macy's stock had resulted in a change in ownership, it reassessed a Macy's store. The store's tax per square foot jumped to a rate 250 percent higher than its competitor's in the same shopping center. The company challenged the reassessment as competitively unfair and a violation of interstate commerce laws. The U.S. Supreme Court was scheduled to hear the case of *Macy & Co. Inc. v. Contra Costa County* in 1991. However, Proposition 13 advocates boycotted Macy's, and the company withdrew its case.[50]

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[48] Goldberg, Lenny. "The Empire Has No Clothes: Infrastructure, Sprawl, Local Government Finance and the Property Tax." California Tax Reform Association: Sacramento, (5).
[49] Main, Fred. California Chamber of Commerce. Personal interview, 11 Apr 2003.
[50] Youngman, Joan M. "Special Problems in the Valuation of Business Property." *Taxation of Business Property: Is Uniformity Still a Valid Norm?* Ed. John H. Bowman. Westport: Praeger, 1995, (148-9).

Legislative Options

The Legislature could consider revising the reassessment practices that govern properties owned by legal entities to address one or more of the principal issues discussed in this paper. These four issues include loopholes, tax evasion, a disparity between homeowners and businesses in the share of total state property taxes paid, and disparities in tax assessments among neighboring businesses.

SB 17 (Escutia) would require publicly traded companies to file property statements with the BOE, require the BOE to notify assessors of any changes in ownership, and increase penalties for failure to file a change-in-ownership statement based on a change in control of a legal entity. For more complete description of SB 17 see Appendix, page 35.

The remainder of this section highlights additional options for addressing the four issues raised in this paper.

Addressing Cumulative Transfer Requirements

Tax law could be revised to stipulate that a change in ownership of a legal entity occurs when a majority of ownership shares have cumulatively changed hands since the last change in ownership. This would directly address a loophole that allows, for example, a situation where the entirety of a legal entity changes hands but a reassessment never takes place because at no time did a single individual acquire a majority share.

The success of this option would depend largely on the ability of the state to track and enforce changes in ownership. Currently, the state and county reporting systems are heavily reliant on self-reporting by the owners of legal entities. Additionally, the transaction of stocks in publicly held corporations provides another monitoring difficulty because of the high volume of stock transactions that can take place quickly and because the same stocks may be transacted multiple times. The state would need to determine how to define change in ownership through stock transactions.

Reducing the Majority Transfer Threshold

Alternatively, the law might be amended to reduce the threshold at which a change in ownership and reassessment are triggered. In other words, instead of a majority acquisition triggering a reassessment, the threshold might be 20 percent, for example.

While this alternative would not directly address perceived loopholes in tax law, it might be easier for the state and counties to monitor because assessors would need to identify only single transactions rather than tracking and tallying multiple transactions. The state would need to decide whether to mandate a full reassessment of properties or make reassessment proportional to the amount transacted, as occurs when properties are transacted between individuals. Many businesses might argue that a full reassessment after only minority changes in ownership would place an unfair financial burden on owners.

This alternative might be easier to monitor than the cumulative transfer requirement, but its success would be largely dependent on the ability of state and county officials to identify changes in ownership. Further, owners of a legal entity might find ways around a threshold of, say, 20 percent by structuring two 10 percent transactions, perhaps with at least one running through an intermediary.

Eliminating the Proportional Transfer

The proportional transfer allows corporations to transfer properties from one subsidiary to another without triggering reassessment as long as the ultimate ownership control of the property is the same before and after the transfer. In contrast, when Proposition 13 was first enacted, the law reflected a "separate entity" approach advocated by the Legislature's Proposition 13 implementation task force. The "separate entity" approach stipulated that ownership was determined by the entity itself rather than ownership control of the entity. However, business interests raised concerns that the original approach limited their ability to reorganize their businesses without triggering higher assessments, and the Legislature amended the law to allow proportional transfers.

Now, advocates for legal reform argue that the proportional transfer is abused by businesses and is another means by which property ownership can change without resulting in a reassessment. The Legislature could eliminate proportional transfers in two ways. First, it could eliminate Revenue and Taxation Section 62(a)(2) that expressly allows proportional transfers. In so doing, any business reorganization that resulted in a new business entity owning property would trigger a reassessment. County assessors would simply need to identify that a new entity owned the property, rather than determine whether the ultimate control of the business had unchanged. While this would make identification of changes in ownership somewhat simpler for county assessors, eliminating the proportional transfer would a) probably only affect a small number of businesses and b) potentially discourage some businesses from engaging in what would otherwise be efficient reorganizations.

Alternatively, the Legislature could fully adopt the "separate entity" approach, redefining change in ownership for properties owned by legal entities as any transfer of property between entities, including entities owned by the same parent corporation or other owners.

This was the approach originally recommended by the task force charged with designing the Proposition 13 implementation strategy for the Legislature.[51] The benefit of this approach is that it would make the administration and identification of changes in ownership of legal entities much simpler for county assessors. Assessor's offices would be required to identify when a new business entity acquired ownership of property without concern for how ownership of that entity changed over time. This means that business reorganizations and incorporations would result in changes in ownership – and reassessment of properties. On the other hand, however, the separate entity approach would also mean that many properties would never undergo reassessment even as the individual owners of the legal entity changed over time – the very loophole advocates of SB 17 are hoping to close.

Reducing Tax Evasion and Non-Reporting

A Rebuttable Presumption

A rebuttable presumption refers to an alternative reporting requirement in which all commercial properties regularly (e.g. every three to four years) submit information attesting to the ownership of the property. This requirement would extend to owners of any legal entities sharing in property ownership. The burden of proof would fall on a property's owner to file documentation with the county assessor to prove that there has not been a change in business ownership. If an owner failed to demonstrate that no change in ownership had taken place, the property would automatically be reassessed.

However, such a system likely would require additional resources to enable county assessors to create and maintain a new reporting system. Los Angeles County Assessor Rick Auerbach argues that only a minority of businesses change ownership each year, and that, the program would detect only a small number of changes that would not have otherwise been determined.[52]

Additionally, there is a statute of limitation of 8 years for the state or counties to complete a reassessment on a change in ownership that has not been a willful or fraudulent misrepresentation to the county assessor.

Strengthening Enforcement Mechanisms

As previously stated, failure to submit a Preliminary Change in Ownership form is $25, and failure to respond to a county or state request for ownership information can result in fines up to 10 percent of a business's property-tax assessment. Increases might compel more business owners to fulfill their legal obligations to report ownership changes. The eight-year limitation for the state or counties to complete a reassessment on non-fraudulent changes in ownership also could be extended. However, it should be remembered that increasing penalties would not directly

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[51] "Report of the Task Force on Property Tax Administration." (Presented to) Assembly Committee on Revenue and Taxation. Sacramento, 22 Jan 1979, (45).
[52] Auerbach, Rick. Los Angeles County Assessor. Personal interview, 21 Apr 2003.

address perceived loopholes in property-tax law that allow multiple minority changes in ownership to take place without triggering a reassessment.

Improving Reporting Methods

Businesses that undergo a change in ownership are required to report that change to the county assessor within 45 days. However, if a business owner fails to report and the state and county do not recognize the failure, then that business will escape reassessment. There may be opportunities to improve state and county abilities to monitor changes in ownership. For example, it might be worthwhile to require that all businesses owning property in California report changes in ownership to the Secretary of State's Office, which already registers businesses. Alternatively, businesses might be required to regularly submit to the BOE a form stating ownership partners and shares of ownership. Also, the Securities and Exchange Commission makes available some information regarding ownership of publicly owned corporations. Access to these information sources might it make it easier for the state and counties to determine changes in ownership.

Improving reporting methods would likely catch some individuals who otherwise would escape reassessment. However, these improved methods probably would be most important in the event that the law were changed to alter the way that change in ownership is defined. As described above, in the case of either making transfer requirements cumulative or reducing the majority transfer threshold, better reporting mechanisms would be needed to help ensure compliance by taxpayers.

Mandating Audits of Ownership Records and a Study of Tax Evasion

The Legislature could consider two additional alternatives. First, the state could mandate audits of the ownership records of all legal entities that own businesses in California, similar to the actions of the IRS for income tax reporting and of county assessors concerning business personal property. In fact, the Legislature could require that when audits are done of business personal property, auditors also investigate the ownership status of the business.

Additionally, because there is much uncertainty over the amount of evasion by owners of legal entities, the Legislature could consider funding a statewide study to determine the extent of this type of property-tax evasion. The results of such a study would inform state lawmakers of the degree to which legislative efforts to compel accurate reporting are effective and if additional measures are warranted. Should these studies determine that tax evasion is a significant problem, the Legislature could consider instituting tougher penalties, more stringent reporting requirements, and perhaps even the rebuttable presumption. However, should the studies determine the commercial property tax evasion rate to be low, the Legislature might decide that the problem is not large enough to warrant more expensive remedies.

Instituting a Split Roll

Because Proposition 13 was a voter-approved initiative to amend the California Constitution, making direct revisions to it would entail voter approval of another constitutional amendment, which could be placed on the ballot by the Legislature or through citizens' initiative.

Commercial properties with voter approval could be assessed differently than other properties in an approach that splits the property-tax rolls. All commercial properties could be reassessed at full market value on a regular basis, perhaps on three-to-five-year cycles. These reassessments could take place regardless of any changes in ownership of business properties, while residential properties would retain their Proposition 13 protection from reassessment unless there is a change in ownership. Some would argue that instituting regular reassessment of commercial properties should come with a tax rate lower than 1 percent because of the greater cost burden it could put on businesses.

A split roll would remove issues associated with tracking and enforcing change in ownership, since proving a change in ownership would no longer be necessary for reassessment. This approach would lessen the disparity in property taxes among neighboring businesses.

Conclusion

This analysis has been intended to inform the debate surrounding reforms to the commercial property tax assessment system and clarify what is in many ways a complex set of laws and issues. It has reviewed several problems commonly associated with the tax code and implementation of laws regarding change in ownership of legal entities that own California properties. Specifically, these problems include legal “loopholes” that permit businesses to change ownership without triggering a reassessment of their properties, gaps in the reporting process that limit the ability of the state and counties to identify all changes in ownership, and property tax revenues lost due to those two problems. However, the extent of each of these problems is difficult to estimate with certainty because no entity tracks minority changes in business ownership, nor has anyone conducted an evaluation of commercial property-tax evasion in California.

Commercial property-tax loopholes and tax evasion lead to a greater share of property tax burdens for homeowners and greater property tax disparities among competing businesses. California’s acquisition-based assessment system creates and perpetuates inherent inequities in property-tax bills among the owners of similar residential properties and similar commercial properties. Loopholes and tax evasion exacerbate them. This report has reviewed a variety of alternatives to address the problems associated with a change in ownership of legal entities. As California moves into its 26th year under Proposition 13, it will be up to policymakers and citizens to determine the best course.

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Appendix

Proposition 13: Article XIIIA of the California Constitution, As Approved by California Voters on June 6, 1978

Section 1.

(a) The maximum amount of any *ad valorem* tax on real property shall not exceed one percent (1%) of the full cash value of such property. The one percent (1%) tax to be collected by the counties and apportioned according to law to the districts within the counties.

(b) The limitation provided for in subdivision (a) shall not apply to *ad valorem* taxes or special assessments to pay the interest and redemption charges on any indebtedness approved by the voters prior to the time this section becomes effective.

Section 2.

(a) The "full cash value" means the county assessor's valuation of real property as shown on the 1975-76 tax bill under "full cash value" or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment. All real property not already assessed up to the 1975-76 full cash value may be reassessed to reflect that valuation.

(b) The fair market value base may reflect from year to year the inflationary rate not to exceed 2 percent for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction.

Section 3.

From and after the effective date of this article, any changes in state taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature, except that no new *ad valorem* taxes on real property, or sales or transaction taxes on the sales of real property may be imposed.

Section 4.

Cities, Counties and special districts, by a two-thirds vote of the qualified electors of such district, may impose special taxes on such district, except *ad valorem* taxes on real property or a transaction tax or sales tax on the sale of real property within such City, County or special district.

Section 5.

This article shall take effect for the tax year beginning on July 1 following the passage of this Amendment, except Section 3 which shall become effective upon the passage of this article.

Section 6.

If any section, part, clause, or phrase hereof is for any reason held to be invalid or unconstitutional, the remaining sections shall not be affected but will remain in full force and effect.

SB 17 (Escutia), as amended 5/22/03, is pending in the Legislature and would:

(1) Extend change of ownership notification requirements from 45 days to 60 days, and increase the penalty for failure to notify as follows: (a) 10% of the taxes owed in the current year on all of the real property owned by the legal entity in the state or (b) $10,000, whichever is greater.

(2) Impose a penalty of (a) 25% of the taxes owed in the current year on all the real property owned by the legal entity in the state or (2) $25,000, whichever is greater, if a person or legal entity misrepresents the occurrence or nonoccurrence of a change in ownership on the reporting statement.

(3) Require the Franchise Tax Board to notify the State Board of Equalization if a company fails to respond to the question of whether a change of ownership has occurred.

(4) Require a publicly traded company to file a property statement with the Board of Equalization that lists all of the real property owned or leased in the state by the company and impose a penalty on the company of 10% of the current year's taxes on all real property in the state for failure to file a complete statement.