Commission on the 21st Century Economy
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Santa Clara County

My name is Larry Stone. I am here today in my capacity as the Assessor of Santa Clara County, which has California's 4th largest assessment roll, at over $300 billion. I have served as Assessor for 14 years including a term as President of the California Assessors' Association.

Before I became a full-time elected Assessor, I was a City Council member and Mayor of the City of Sunnyvale. During most of my professional career, I've been in the real estate investment and development business. I started as a financial manager on Wall Street, and later co-founded a Bay Area real estate investment and development firm.

Thank you for the opportunity to address the Commission. Judging by your prior meetings, the depth of the discussion and the caliber of the presentations, you have taken this assignment very seriously, and I am eager to contribute to your proceedings.

Let me start by stating that I agree with the Governor's general premise, California's tax system is broken. Moreover I am hopeful that you will propose sweeping reforms to help restore California's promise.

Property tax remains one of the most stable forms of revenue and annually generates over $45 billion in tax revenue in California. In Santa Clara County, property taxes generate over $3 billion in revenue. And in my County property revenue is allocated as follows:

45 percent State Public Education (schools)
14 percent Cities
18 percent County
10 percent RDA's
7 percent Community Colleges
6 percent Special Districts

The last <u>major</u> reform of the property tax system was Proposition 13. It was highly controversial, and ever since has been at the center of state and national debates about the measure's intent and fairness.

One of the major disputes that was raised immediately after Proposition 13 passage was the issue of equity between the taxation of residential properties and commercial and industrial properties. The recently proposed solution has been a split roll.

The split roll generally means taxing commercial property differently than residential property rate. More recently it has also been used to describe legislation attempting to redefine a "change in ownership" as it applies to the transfer of ownership interests in legal entities (i.e., stock or ownership shares in a corporation or partnership)  Either way, the split roll attempts to identify non-voting taxpayers (business) and assess them differently than residential property.

Foreshadowing the controversy being discussed today over split roll, the original Task Force that wrote the law implementing Proposition 13 could not reach consensus on the split roll.  They ended up kicking the ball to the Legislature urging them to study the idea of a Constitutional amendment to periodically appraise commercial and industrial property at market value.
Today, I am here to address primarily the issue of the implementation of the split roll, and I do so wearing exclusively my Assessor hat, as an impartial administrator charged with implementing the law regardless of my personal views.  In other words, I am not here as a citizen concerned with maximizing revenue for schools and local services.  I certainly will not discuss the fairness of Proposition 13, as it is not fair.

Nevertheless, I oppose the split roll for the simple reason that it would be impossible for assessors to implement.  I am a Democrat who has served in local elective office for over 30 years.  I am not insensitive to the state's fiscal crisis.  But as the administrator of the property tax system, I am certain the split roll is not the solution, nor can it be implemented cost effectively. That opinion is shared by the California Assessors' Association in a published white paper.

The problem is, while it would generate much needed revenue to deal with the state's fiscal crisis, the revenue generated would be far less than projected, most likely between $1 to $3 billion per year.  The split roll fundamentally does not address the inequities that exist in the current system, in which owners of identical properties can pay a property tax differential of 10 or more times.

More importantly the revenue would not be immediate. Instead it would come over several   years.  In addition, a split roll would create an expensive, administrative nightmare for assessors.

To assess at market value, every commercial and industrial property annually or periodically, would require a significant increase in my appraisal staff.  It would create, in the first five years, a nearly impossible situation to manage, as the assessment of commercial and industrial properties are the most complex and time consuming to complete. Without a doubt, the filing of assessment appeals would skyrocket, and become a very real burden for assessors.

As would be expected, commercial and industrial properties require the most experienced professionals to assess. Typically, these individuals must have a minimum of five years of experience assessing complex properties. Unfortunately, this pool of talent has diminished as fewer and fewer individuals have entered the appraisal field, since the S&L debacle in the early 90's. A split roll would only exacerbate this problem, as senior appraisers would abandon the public sector for much more lucrative opportunities in the private sector, representing appellants.

The LAO has conservatively estimated the annual cost to Assessors in the low tens of millions. That estimate is likely to be very low. In Santa Clara County, we estimate the appraisal and support staff would need to increase by 20 percent. In Los Angeles County, using statistics from 2004, the L.A. County Assessor estimates a split roll would demand an additional 300 appraisers and supervisors to handle the new annual reassessments and subsequent assessment appeals. In Los Angeles County alone, the annual cost to staff these positions is estimated at over $24 million, and that estimate is now five years old, and has certainly increased since 2004. Additional facility costs and clerical support would add another $2 million, for a total in today's dollars exceeding $30 million. These costs would be permanent, and would increase over time. In contrast, the assessed values of non-residential properties would fluctuate, both up and down in response to the market conditions as we are now experiencing in the current meltdown of property values.

To date, there are no provisions in these initiatives to immediately fund assessors and provide the startup costs necessary to implement the change. Administration of the property tax system has been seriously challenged to provide adequate service since the passage of SB188 in 1991. SB 188 exempted schools from paying their fair share of the property tax administration. Without the proper funding, this change will only exacerbate the current statewide problem. Currently, due to budget cuts, my staff is 2 percent smaller than it was 14 years ago despite increased workload and an assessment roll which has risen from $115 billion to $300 billion. Additionally, the revenue that assessors currently receive, from the State to process supplemental assessments of non-residential properties, would disappear.

To attract experienced appraisers, significant increases in compensation would be required. Conservatively, I estimate my budget would have to increase by at least $3 million annually. To offset that increase, the split roll would have to generate over $2 – 2 ½ billion in additional assessed value for the County just to break even, because Santa Clara County receives only 18 percent of the total property tax revenue.

It has been suggested that the solution to the assessor's concern regarding the increased workload is under a split roll, assessors would no longer have to do individual appraisals of these properties.

Instead it has been suggested that assessors can merely use a Computer Assisted Market Analysis software program, known as CAMA, to the work. I call this the Disneyland approach, as Disneyland is one of the few places with significantly undervalued land. The assumption is based upon the faulty premise that most of the low assessed values are attributed to very low, very old assessed land values beneath commercial and industrial properties. The theory assumes assessor's could easily use a CAMA to bring those land assessments to market value annually.

The problem with the idea is that bringing just the land to market value annually without assessing the value of the entire property, including buildings (currently are arbitrarily increased by 2 percent a year per Proposition 13), would result in massive over assessments of most commercial and industrial properties.

As assessors, we are required to determine, upon sale or new construction, value of the land <u>and</u> buildings. Over time land appreciates while buildings depreciate, but the combined assessed value usually remains far below the market value, until there is another change in ownership or new construction.

While this would not apply in a split roll, the problem is best illustrated with a home. In the 1960's a home in Palo Alto may have sold for $50,000. By 2008, the assessed value may have risen to $150,000; $75,000 for the land and $75,000 for the building. In Palo Alto, this would be a classic "scraper". A new owner might acquire the property for $1 million and scrape the home to build a new house. In effect they were buying the land for $ 1million as the house was for all intense purposes, functionally obsolete, and no longer of much value. In fact, the land value may have been reduced to account for the cost of demolishing the old house.

Yet on the day before the sale, the building was assessed at $75,000. In the example, we would bring the land to market value, $1 million, and then add the $75,000 to arrive at the total assessed value of $1.075 million, even though we know the total market value is $1million because that was the sales price for the land.

In Santa Clara County, we had a more dramatic example with IBM. IBM acquired the land for their main production facility in the mid 1950's. Many of the improvements had been built in the 50's and 60's and were near the end of their useful lives. Had this methodology been utilized, the potential over assessment for the 2003 assessment roll would exceed$ 335 million.

With wide swings in property values, particularly in Silicon Valley, the split roll will not generate a consistent amount of new property tax revenue. Imagine if there had been a split roll in place preceding the current market down turn. Instead of reassessing a handful of recently bought and sold commercial properties, we would be reducing the assessed values of thousands of properties with billions of dollar swings in assessed values.

The stability of the property tax system, a major asset of the current system, would be challenged and instead replaced with a much more volatile system more akin to the income tax system.

There are practical implementation problems as well. Even if you "ramp up" over several years, where do you start? How do you choose which properties will experience the "joy" of being the first to be re-assessed annually, at market value?

If the property selection is totally random, how does the hotel, gas station, shopping center, office-building owner compete with the same type of property down the street, where reassessment to market value comes possibly four years later?

If the split roll is phased in by property type, is it fair to the shopping center owners to pay taxes based upon current market value, when hotel owners don't? If it is done by geographic area, how fair is it for commercial property owners in Gilroy (South) to be assessed at market value, if Palo Alto (North) property owners are not?

No matter how it is implemented, assessment appeals would skyrocket with a split roll. The costs to defend and the uncertainty it would create could be the downfall of the split roll proposal.

As a political sweetener, proponents of the split roll have dangled the prospect of a exempting small and medium business from paying property taxes on the assessed values of business personal property, including machinery, equipment and computers. As a County with the second highest assessment of business personal property, just behind Los Angeles, and nearly twice as much as the state average, Santa Clara County and others like us would be disproportionately impacted.

From a tax administration point of view, this is an awful suggestion. It is not only the wrong way to devise tax policy, but assessor's would have to continue expending the same amount of staff and budget resources only to then turn around and exempt potential revenue.

Fortunately, there are other options to reform the system; none of them are perfect. All of them, like Proposition 13, create winners and losers. Each is controversial.

The first set of proposals falls into variations of the split roll. These proposals all change the property tax system for the non-residential property owner. The two main variations are:

a. Establish a different tax rate for C & I properties or,
b. Increase annual inflation factor for C & I properties to reflect the actual rate of inflation or some variation (cost of governmental services increased at the rate of inflation).

Currently the annual increase in assessed value is limited to no more than 2 percent. Instead of 2 percent, you could raise the limit to 3 percent or 4 percent. Another proposal would establish a different tax rate based upon the value of a property. A sort of tax the wealthy philosophy. Yet another proposal, seeks to substantially increase the homeowner's exemption at the same time you establish the split roll. That's designed to encourage "voters" to support a split roll.

Another approach to the split roll is something I refer to as the "backdoor" approach. For years, advocates for a split roll have attempted to legislatively redefine a change in ownership and essentially create the same result as a split roll. They have argued that "ownership" in a business can change hands many times without triggering a reassessment of the property. Proponents believe this requires only legislative action.

They are partially correct.

What triggers a reassessment can be very complicated. Unfortunately, there is no single rule or single path that guarantees exclusion from non-assessability. Most assessors have an entire unit of assessment professionals dedicated to examining each transfer transaction to determine whether or not it is a reassessable event. Millions of dollars can ride on the decision of whether or not to reassess commercial and industrial properties.

The most talked about exclusion concerns limited partnerships. For example in 2002, E&J Gallo bought the Louis M. Martini Winery in St. Helena, over 1500 acres. The sellers were approximately twenty shareholders of the family corporation that had owned the property as a corporation since 1933. The buyers were approximately 20 members of the Gallo Family who purchased the shares of the sellers in a single transaction. However, because the corporation was subject to the change of control test under Rev and Tax 64(a) and 64(c)(1), not the cumulative change in control rules of 64(d), and because none of the buying family members acquired a majority interest in the corporation, there is no reappraisal of any of the interests. While I agree this exclusion is a problem, I seriously doubt it is pervasive. In fact, I know of no major situation like this in my County.

In reality, when a legal entity, such as a corporation, buys another legal entity, it is 100 percent reassessed. I realize there has been some confusion on this point, but I can assure you assessors uniformly are reassessing changes in ownership when the majority of the controlling interest has been discovered. Let me provide a few examples, including one that I believe has been discussed previously by this Commission.

In 2002, HP acquired Compaq/Tandem. In Santa Clara County that acquisition resulted in the transfer of 12 parcels. All were 100 percent reassessed increasing the assessment roll from $140 million to $165 million.

Another major transfer was Blackstone's acquisition of Equity Office. In this one transaction, 35 properties in Santa Clara County transferred increasing the assessment roll by a quarter of a billion dollars.

A more current transfer that has been in the headlines recently was Chase/JP Morgan's purchase of WaMu. Our office identified 14 commercial buildings, and hundreds of foreclosed residences owned by WaMu that will be reassessed later this year to reflect the change in ownership. In this instance, the discovery of this transfer was through the media.

Even changes in the control of corporations, or other legal entities, where title to property remains in the same corporate name and nothing has been recorded. The assessors have tools to discover these changes in control and reassess the property.

The major one being the Legal Entity Ownership Program (LEOP), which started operation less than 5 years after Proposition 13 in January 1983 as a result of Assembly Bill 152. LEOP requires the Board of Equalization to participate in discovering changes in the control of corporations, partnerships, and other legal entities.

Basically when the corporation files its state income tax, the corporation is required to report any change in control of the corporation. The Franchise Tax Board notifies the State Board of Equalization who then notifies the assessor who investigates whether a reassessable event has occurred.

Cooperation is more than just strongly encouraged. If the legal entity does not respond to the BOE request, the legal entity is imposed 10 percent penalty of the taxes on <u>all</u> of the real property owned by such entity, whether or not a change in ownership or control occurred.

If transfer of property is not reported or recorded, and the assessor discovers it later, the assessor can roll correct, going back eight years unless there is fraud. With fraud, the assessor can go back to the actual date the change in ownership occurred.

In 2008, the Santa Clara County Assessor's Office discovered 27,475 changes in ownership and nearly 8,000 newly constructed properties, <u>all</u> triggering new assessments. Of the total reassessable transfers, only two tenths of one percent are the result of changes by legal entities. However, the 137 legal entity transfers discovered in 2007, had an assessed value of more than $2 billion, which does not include any changes in assessed value to reflect these transfers.

So while legislative proposals to provide the Assessor with more tools to discover changes in ownership or close legitimate loopholes may seem like a good idea, the <u>inevitable result, a split roll, creates far more problems than it ever solves.</u>

In addition to split roll, I would like to call your attention to a few additional timely issues relating to property taxes.

First concerns the assessment of computer software. While a lot of computer software added on to a computer was exempted back in the early 70's to help what was then an industry in its infancy, software that was considered integral to a machines operation was assessed. The classic example is the software in a car or airplane. Without this embedded software it would not function safely.

A recent appeals court ruling, Cardinal Health vs. Orange County, has upended this long precedent and has the real potential to further exacerbate the budget crisis facing State and local governments.  In short, the Court narrowly interpreted an outdated, 35 year old statue that would force Assessors to value and assess machinery and equipment as if there was no computer technology embedded within it.  The Courts have repeatedly encouraged the legislature to update the statue.  The legislature has thus far declined.

Absent legislative intervention, the California Assessors' Association has estimated a potential annual revenue loss of $1.35 billion in property taxes on business personal property.

The other issue I mentioned in my letter to the commission and concerns the two-thirds requirements to balance the budget or raise taxes.  Allowing one-third of the legislature or the voters to dictate the State's fiscal future has created aberrations in policies that have contributed to the State financial morass.