

A “SPLIT” IN CALIFORNIA’S PROPERTY TAX SYSTEM: WHAT’S POOL GOT TO DO WITH IT?

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Most owners and tenants of commercial properties are at least aware of the recent efforts to create a “split roll” property tax system in California. Many have believed that the proposed legislation, if enacted, will effect only minor changes to Proposition 13. Some recognize that the massive deficits now facing state and local governments have accelerated both the pace and the scope of suggested modifications to the current system. Few, however, realize the potentially dramatic effect – on both commercial owners and local governments – of a class-action lawsuit working its way through the Orange County court system.

The case is County of Orange v Orange County Assessment Appeals Board No. 3 (referred to here as “Pool”). Plaintiff Pool is the owner of a single-family home in Seal Beach; he also is a property tax attorney. Pool was able to convince a trial court judge to render an interpretation of Prop. 13 that no taxpayer, no legislator, no judge and no jury has so much as even suggested in the 25 years since passage of the proposition. If not reversed on appeal, the decision, which misconstrues the language of the numerous applicable property tax statutes and regulations and flies in the face of reason and fairness, will cost Orange County more than \$1 billion. Copy-cat litigation has been filed in a numerous other counties. Do the math and you get a sense of the potential impact throughout California.

So what’s Pool all about? Pool purchased a residence in late 1995 for \$330,000, and his property was reassessed at the purchase price. Prop. 13 permits annual assessed value increases based on CPI, to a maximum of 2%, over the original purchase price. The Orange County Assessor, evidently acknowledging a flat real estate market, made no increase in the assessed value for the following tax year – although he could have increased it by 2% to \$336,600. The market apparently improved the next year. The Assessor determined that the property’s market value was higher than \$344,000; however, following a procedure that has been utilized by assessors throughout California for almost 25 years, the Assessor limited Pool’s assessed value to \$343,332, i.e., a 2% increase over the prior year’s \$336,600 “limit.” Pool cried foul. Because the Assessor voluntarily had kept the prior year’s assessed value at \$330,000 – not the \$336,600 limit – the \$343,332 assessed value represented a one-year increase of more than 4%; and Pool asserted that the increase violated Prop. 13’s annual 2% limitation.

In agreeing with Pool, the trial court simply superimposed Prop. 13's limitation on permitted annual increases to a property's original acquisition cost onto any annual increase in assessed value. At first blush, the Pool decision seems like a great windfall for property owners. But when you view it in the context of the current Bay Area market, you begin to understand the fiscal impact. A property's assessed value cannot be increased over the acquisition cost by more than 2% annually, even in the hottest of real estate markets. When the market takes a dive, under Prop. 13 the property owner can seek an immediate reduction in assessed value. Since Prop 13 has a ceiling but no floor, the owner can get a reduction of 10%, 20% or even 50% (think Silicon Valley commercial market in 2002!); and now, under the rationale of Pool, that reduced value thereafter could never be increased by more than 2% annually!

Local governments have long viewed Prop. 13 as an unconstitutional assault on their fiscal lifeline but most have adapted quite well over the 25 years since its passage. Then along comes Pool, which is akin to Prop. 13 on steroids: the limits on tax increases during boom times that the proposition was designed to address would be superimposed on assessed values ratcheted down during the leanest of markets. A classic we (property owners) win and you (local government) lose scenario. And certainly not one that local governments are likely to tolerate.

The Pool decision, if not overturned on appeal, may be a win for residential owners but it will be a pyrrhic victory for owners of commercial properties. Faced with the largest deficits in history, both the state and local governments are slashing personnel and programs. If those deficits balloon, in part, as a result of tax revenues lost to a new court-created limitation, somebody is going to have to feel the government's pain; and it is not likely to be residential owners, whose votes were responsible for the passage of Prop. 13. The split in "split roll" could get a whole lot wider, and commercial property owners and tenants will learn first-hand what life in California was like in the 1960's and 1970's – before passage of the proposition.

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