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Proposition 15 and California's 2020 Ballot

BY DAIN FEDORA

Setting the Stage

A new measure seeking to reform California's Proposition 13 will be on the state's November 2020 ballot; a reform that is anticipated to alter the commercial real estate landscape so much so that business organizations representing commercial and industrial real estate property owners are mobilizing to raise $100 million to defeat it.

Dubbed "Proposition 15," this overview explores today's property taxes, the new measure and concludes with the implications for California's commercial real estate industry.

Proposition 13 as it Stands Today

Approved by voters in 1978, Proposition 13 set state property taxes—for both residential and commercial real assets—at one percent of the purchase price with capped annual increases at two percent or the rate of inflation, whichever is lower. Californians who hold their property for a long time end up paying far less in taxes than new buyers, with the only exceptions being new construction on a site, which resets the assessed value when a new building delivers or a decline in value associated with 1978's Proposition 8.

State property taxes skyrocketed by 120 percent from 1974-1978, and most voters, weary of the perception of unfettered government spending, took matters into their own hands. Flash forward to the present, and critics of today's Proposition 13 are quick to note California is losing billions of dollars per year in revenue, a portion of which could go to its public school system.

The Proposal for Reform

Proponents of the new reform, including social justice groups, teachers and various labor unions want a split-roll approach that will tax commercial assets at fair market value, with reassessments to occur every three years. Homeowners will continue to pay the one percent of purchase/two percent annual caps under the current guidelines. Agricultural buildings and owners of commercial and industrial properties with a combined value of $3.0 million or less are also exempt.

The reform will increase state tax revenue by $8.0 to $12.5 billion per year. Once administrative costs are covered (ranging from $500 million to $800 million), 40.0% of the revenue will go to public schools and community colleges, while local governments will collect the remaining 60%.

If the measure passes, the change from the purchase price to market value would be phased-in beginning in fiscal year 2022-2023. Properties, such as retail centers, whose occupants are 50% or more small businesses would be taxed based on market value beginning in fiscal year 2025-2026 (or at a later date that the legislature decides on).

The Hypothetical Impact on an Office Property Owner

The Original Proposition 13

Year	Assessed Value	Annual Increase in Assessed Value	Annual Taxes (at a 1.0% tax rate)
2004	$50,000,000	2.0%	$500,000
2005	$51,000,000	2.0%	$510,000
2006	$52,020,000	2.0%	$520,200
2007	$53,060,400	2.0%	$530,604
2008	$54,121,608	2.0%	$541,216
2009	$55,204,040	2.0%	$552,040
2010	$56,308,121	2.0%	$563,081
2011	$57,434,283	2.0%	$574,343
2012	$58,582,969	2.0%	$585,830
2013	$59,754,628	2.0%	$597,546
2014	$60,949,721	2.0%	$609,497
2015	$62,168,715	2.0%	$621,687
2016	$63,412,090	2.0%	$634,121
2017	$64,680,332	2.0%	$646,803
2018	$65,973,938	2.0%	$659,739
2019	**$67,293,417**	**2.0%**	**$672,943**

VS.

Proposition 15

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2019	**$104,500,000**	**A fair-market value assessment occurs, which is hypothetically 109% higher than 2004's figure.**	**$1,045,000**

If the new reform were in effect today, then the owner paid $372,066 more in taxes in 2019.
Or, 55.3% more when comparing the original Proposition 13 to Proposition 15.

The Hypothetical Impact on an Industrial Tenant

A modern, vacant 500,000-square-foot warehouse facility sells in the Inland Empire for $65/SF in 2014.
The building is quickly leased to tenant on a NNN basis, with a 12-year lease term in place.

The Original Proposition 13

Year	Assessed Value	Annual Increase in Assessed Value	Annual Taxes (at a 1.0% tax rate)
2014	$32,500,000	2.0%	$325,000
2015	$33,150,000	2.0%	$331,500
2016	$33,813,000	2.0%	$338,130
2017	$34,489,260	2.0%	$344,893
2018	$35,179,045	2.0%	$351,790
2019	**$35,882,626**	**2.0%**	**$358,826**

The tenant pays $0.72/SF in taxes per year
($338,826 / 500,000 SF)

VS.

Proposition 15

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2018	$35,179,045	2.0%	$351,790
2019	**$50,000,000**	**A fair-market value assessment occurs, which, based on sale comparables, reflects a $100/SF average, for the same facility**	**$500,000**

The tenant pays $1.00/SF in taxes per year
($500,000 / 500,000 SF)

** a hypothetical and consistent 2.0% per annum increase in the assessed value from 2004-2018 was used in order to emphasize the change in 2019.*

By-the-Numbers Case Studies

The Hypothetical Impact on an Office Property Owner

Real estate values in California are among the priciest in the nation, with pronounced growth in recent years. For office properties, the average sold price was $448/SF in 2019, up 109% from 2004, according to data from Real Capital Analytics.

Bearing this average increase in mind, the hypothetical taxes for an office asset under today's guidelines versus the proposed reform is above. Each assumes the building sold for $50.0 million in 2004, and the buyer remains the owner. The top-right table assumes the reform is already in effect, with a fair-market value reassessment occurring in 2019.

The Hypothetical Impact on an Industrial Tenant

The above lower tables highlight the tax fees for a big-box tenant with a triple-net (NNN) lease in place; an agreement in which the tenant pays all expenses of the property, including real estate taxes, building insurance and maintenance. If the reform was in effect in 2019, then the tenant paid $1.00/SF that year in taxes. Compare this to $0.72/SF under the original Proposition 13 guidelines. A 38.9% differential.

California's Business Environment

Increasing taxes for commercial property owners will lead to higher rents for tenants, which drives up the cost for businesses to operate in California. This is in addition to a state minimum wage set to reach $15/hour by 2022, the highest income tax rates in the country and expensive housing costs. Small businesses, which employ nearly half of all employees in California, will likely consider out-of-state relocations.

California's reputation as a business friendly state is already poor based on 2019 studies, with Chief Executive ranking it as last in the nation, CNBC placing it at 32nd and Forbes having it as 29th. Forbes ranked Arizona and Texas as 17th and third, respectively; both states are the beneficiaries (among others) of business relocations from California over the last two decades.

A study, entitled "Why Companies Leave California" estimated 13,000 companies relocated out-of-state from 2008-2016, which equated to 275,000 jobs and $76.7 billion in diverted capital funds.

What Are the Implications for Commercial Real Estate?

Laws new to California sometimes migrate to other states, meaning Proposition 15 will set a new precedent that escalates commercial property taxes at a steep rate. Although assessed values will fluctuate in economic down- and up-cycles, the state's real estate values are substantially higher over the long term, whether the timeline is 15, 20 or 30 years.

While most office, industrial and retail tenants will see higher rents, Fortune-caliber companies are better insulated from higher occupancy costs than smaller and mid-sized entities since their financial reserves are deeper. For appraisers, assessments every three years will create high-demand for their services. "More current data" will make the underwriting of debt and capital markets offerings an easier task. For investors weighing multiple state options, such as where to locate a business or where to develop commercial projects, California's variable tax rates will throw a curveball in their decision-making. For smaller owner-occupiers, sale-leasebacks, especially in a down-cycle, could increase as well. In the end, thoughtful, up to date market intelligence will be paramount in all scenarios.

Sources: *Ballot Pedia, Blue Water Credit, NKF Research, San Francisco Chronicle, South Star Communities*

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