How to Comply with Property Tax Limitations and Raise Taxes on Property at the Same Time

by Donald G. Hagman

In the last quarter of the 19th century, constitutional debt limits were being swept into state constitutions. One popular limitation is that state and local governments cannot incur debt unless it is approved by a vote of the people and extraordinary majorities are often required.[1] Given such a debt limit in California, how is it that Los Angeles County has $516.1 million in debts, only $18.1 million of which were approved by the voters?[2] The answer: clever lawyers.

In the last quarter of the 20th century, constitutional property tax limits are sweeping the country. California's Proposition 13 was adopted on June 6, 1978. Its progeny will be voted on in Idaho, Michigan, Nevada, and Oregon on November 7, 1978.

Among its other features, Proposition 13 limits real property taxes to 1% of market value (cutting yearly revenues from property taxes in California from $12 billion to about $5 billion) and precludes other taxes from being increased except by two-thirds vote of all members of the legislature at the state level or a two-thirds vote of those eligible to vote at the local level. Oregon's Ballot Measure 6 is identical, except for a 1½% limit.

The thesis of this discussion is that these limitations, just as debt limitations, are legal creampuffs in the hands of clever lawyers. Their efficacy is in their political message, not in their legal efficacy. Assuming diminishment of political fervor about tax limitation, therefore, the constitutional limits are only temporary palliatives to high taxes on property.

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EXPANDING THE PROPERTY TAX BASE

The first proposal for legally avoiding a Proposition 13 type tax limitation is to return to the so-called general property tax system which prevailed earlier in our history. For example, the California Constitution of 1879 required that "all property . . . shall be taxed in proportion to its value" and "all property subject to taxation shall be assessed for taxation at its full cash value." If we implemented today a maximum 1% property tax rate on all property, $125 billion in property tax revenues would result. That is a figure calculated by using the best estimate of national assets in 1966 of $5.8 trillion and in 1973 of $9.9 trillion[3] and assuming the same growth rate through 1978, meaning national assets must be about $12.5 trillion. The amount of property taxes actually to be collected in 1978 is about $69 billion.[4]

States, of course, vary in how much property taxes they now impose and how much a 1% maximum on all property would yield. Wealth statistics are difficult enough to find for the nation; they are virtually nonexistent by state. But one could make a rough approximation. In California, for example, assume the ratio of wealth to national wealth is about the same as the proportion of California personal income is to national personal income. Assume further those proportions have not changed since 1976, when California personal income was 11.2% of national personal income.[5] The full cash value of all California property must then be about $1.4 trillion ($12.5 trillion x 11.2%). If all of that property was taxed at the maximum rate permitted against real estate by Proposition 13, it would produce $14 billion in property tax revenues in 1978. That's almost $3 billion over the California Legislative Analyst's estimates of what 1977-78 property taxes in California would have been had the property tax law remained unchanged.[6]

Using the same technique, Oregon's wealth must be about $137.5 billion. A maximum 1½% limit on all that wealth would produce property taxes of $2.06 billion in Oregon. Property taxes in Oregon are only about $1.0586 billion now. Calculations in other states could be similarly made.

Having a broad-based, low-rate property tax has a number of advantages. First, the property tax would be more "neutral," as economists say. People would not invest in particular kinds of property for tax reasons. An unneutral tax causes inefficient deployment of resources. Second, the tax would be easier and hence less costly to administer without loopholes. Third, since no property would be taxed more than $1 per $100 per year, there would be less incentive for evasion than now when taxes on some property approaches ten times that amount. Fourth, the property tax could be made markedly more progressive. For example, the wealthiest 1% of wealth holders in America in 1972 owned 56% of all corporate stock, 60% of all bonds and 53% of debt instruments.[8] The taxation of all property would place a property tax on that kind of wealth and that kind of wealth is the biggest loophole under the existing property tax.

One trouble with the proposal to expand the property tax base is that it would shift taxes and wealth dramatically. The holders of property not now taxed (such as owners of stocks and bonds) would be less wealthy and the holders of

property now taxed (such as homeowners) would be wealthier. Of course, the proposal is no worse than Proposition 13-like limitations since they, too, cause massive shifts in taxes and in wealth.

TAX ON TENANCY

The shift would be smaller if the legislature responded to Proposition 13-like limits by enacting an alternative proposal. The second proposal is to adopt the kind of local tax on property used in England and in a number of other countries. A 1976 English government report describes the English local tax on property:

> . . . as a tax on the benefit of occupation of land and buildings. . . . The benefit of occupation . . . is . . . the rent at which the property might reasonably be expected to. . . . (rent for) from year to year if the tenant bore the cost of repairs, insurance and maintenance. . . . The rents . . . are not the actual rents . . . but the rents which a tenant might reasonably be expected to pay for a tenancy from year to year.

The economic effect of the English tax is somewhat different than the typical American property tax because rental values in England are based on the existing or current uses of property rather than on highest and best use. For example, if one had land in England improved with a single family house, it would be valued in its use for single family purposes even though there was a demand for using the property for a more valuable multiple-family use. Despite the difference in the valuation principles, the tax and wealth shift would not be marked because most properties in America are now valued for property tax purposes at what amounts to their capitalized rental value in existing use—they have no other potential uses. Even if the values are different, valuing properties at existing use is no novel concept to assessors. Property tax law in many states requires certain properties to be assessed at existing use.[11] In California millions of acres of agricultural land,[12] timberland,[13] golf courses,[14] and other open space lands[15] are already taxed under existing use principles as are certain single family houses[16] and historic buildings.[17] Some argue that existing use valuation is fairer in any event because a tax measured by the value of a potential use "forces" conversion of the property to that use in order to pay the higher tax.[18]

No change in economic effects from adopting the English system would occur if the assessor used hypothetical rents based on the assumption that the tenant could change the use to the same extent that the owner could change the use. The taxes under such an English-like tax on property would then be virtually the same as would existing property taxes. Only the rates would be different. For example, suppose a homeowner now has a house with a market value of $100,000 and an assessed value of $25,000 on which the tax rate is $10. The tax is $2,500 per year. Assume that the house could be rented for 10% of its market value per year. Rent of $10,000 taxed at a rate of 25% would result in a tax of $2,500 a year.

Such an English-like tax has been held not to be a property tax, and it thus likely avoids the Proposition 13-like limitation of 1% for "any ad valorem

tax on real property." Unfortunately, an English-like tax is not deductible from the federal or state income tax.[19] It could be made deductible by a change in the income tax laws. But a change in federal law is not likely. Therefore, the problem is to revise the English-like tax on property to make it a real property tax, and thus deductible on the federal return, but not an "ad valorem tax on real property," because Proposition 13-like provisions limit such taxes to 1%.

After considerable scholarly pursuit,[20] the New York legislature has taken the step to make an English-like tax deductible from the real property tax. A bill which became Chapter 471, Laws 1978 on July 6, 1978 has a summary as follows:

> An Act to amend the real property tax law . . . providing that certain renters of residential property have an interest in real property, are personally liable for the real property taxes due on their interest and are entitled to a federal itemized deduction for these real property taxes.

Rather than tax occupancy, the New York statute gives the renter an interest in real estate which is taxed and the renter is made personally liable. The change is really cosmetic. For example, the landlord collects the tax and pays it to the tax collector—but it is the tenant's, not the landlord's, tax that is paid.

Kee and Moan[21] estimated that the federal tax savings to persons in New York City in 1973 under their proposal would be $200 million. Assemblyman Siegel, the main author of the New York legislation, estimated that New Yorkers would save $120 million in federal taxes under his less sweeping legislation.[22] The Kee and Moan scheme applied to California in 1978 could probably have reduced federal taxes to Californians by some $1 billion. Even after Proposition 13, it would still be a good idea, saving Californians some $300 million in federal taxes.

Not faced with a Proposition 13-like limit, New York was not concerned about how to change the English-like tax enough to make it deductible and still avoid Proposition 13-like limits. But lawyers are clever. One could draft a statute which would make a tax deductible from the federal income tax by either owners or tenants but without making it an ad valorem tax on real property.

TAX ON RENTS

Another alternative does just that. The third proposal is to amend state income and sales tax laws to provide for a state-collected, local tax which is the same as the property tax in economic effect but is not an "ad valorem tax on real property." It thus avoids Proposition 13-like limits but is still a tax deductible from the federal income tax.

Consider an owner-occupier of real estate first. The state legislature would pass a law declaring that income of owner-occupiers for state income tax purposes[23] includes imputed rent. Imputed rent is the income an owner would receive on a residence if it was rented out. The occupant, under an imputed

rent scheme, is deemed to be paying rent to the owner even though both are the same person. The owner is then taxed on the rental income. Thus a homeowner with a $100,000 house assessed at $25,000 paying $10 per $100 of assessed value property tax now pays $2,500 in property taxes. After conversion to an income tax and assuming a 10%, $10,000 rental, a 25% surcharge tax on *that* income would also be $2,500.

The legislature in California has already experimented with disguising a tax as an income tax to make it deductible. Senate Bill 1 was proposed to implement Proposition 8, the California Legislature's alternative to Proposition 13 on the California ballot. Until the very last moment, when the feature was defeated by massive lobbying by Realtors, Senate Bill 1 contained a provision for a tax of 5% from the sale of an "owner/occupied" home. So described, the tax would not likely be deductible from federal income taxes.[24] So the legislature provided for the tax by amending the state income tax laws to provide a special tax rate on income from such sales. Deductibility from federal taxes was the intended result.

Tenants could be taxed by a different state-collected, local tax. The sales tax laws[25] could be amended to provide that the rental of real estate was consumption of property taxed under the sales tax. The sales tax rate could be surcharged so that the rate on rentals was 25% rather than the typical percent. Thus, if one rented residential real estate for $10,000 a year, the example previously used, one's sales tax would be $2,500. The owner could collect and remit the tax to the state, just as a retailer now does, but the tax would still be deductible by the renter (consumer).

A SPECIAL ASSESSMENT

A number of further proposals might emerge if one were not just coming up with these off the top of one's head. For the moment, a fourth proposal, to convert property taxes into special assessments, exhausts imagination. A number of special districts in America levy special assessments which look very much like ad valorem property taxes but have been held not to be ad valorem property taxes.[26] A special assessment is not *based* on the value of property (ad valorem), as is the property tax, but on benefit received. But the benefit received under special assessment law can be *measured* by the value of the property receiving the benefit. For example, operation and maintenance assessments of reclamation districts in California are based on a "valuation per acre for each parcel which is in proportion to the benefits to be derived . . ."[27] County water districts levy a tax "in proportion to the assessed valuation of the land . . . benefited . . ."[28] These special assessments are very difficult to tell from property taxes. They are even billed on the property tax bill.

Generally, a special assessment is not deductible from federal income taxes, but a special assessment measured by ad valorem principles and used to pay for current operations as distinguished from capital improvements could be deductible.[29] Ordinarily, a special assessment is assessed only against land, not buildings. But there is nothing in theory which says buildings could not be

regarded as receiving benefits. Thus, while more awkward than some of the others, the proposal for a special assessment on property to replace the ad valorem tax on real property has theoretical possibilities.

Getting around Proposition 13-like 1% limits is as easy as fishing in a hatchery. Depending on convenience, the alternative could be a state tax, a local tax state-collected (as is the local sales tax in many states), or a state tax distributed locally (as is the tax on automobiles in many states). They could be made deductible against federal income taxes, all would evade the Proposition 13-like limit and the tax could be made identical in amount and in distribution to the property tax.

AVOIDING PROPOSITION 13-LIKE LIMITS ON OTHER TAXES

Supporters of Proposition 13-like initiatives, reading another of its provisions, will hope they have anticipated and invalidated the fourth proposal. Section 1.a. of Proposition 13 provides that the 1% limit "shall not apply to ad valorem taxes or special assessments" to pay preexisting debt. The implication is that the 1% limit may apply to special assessments generally or to pay special assessments for new debt. A trouble is that the term "special assessments" in Proposition 13 could be interpreted by a court unimpressed with Proposition 13 to mean that revenues from a specially-assessed property tax could not be used to pay off new debt. A special assessment is not the same as a specially-assessed property tax. Further, the fourth proposal is not limited to a special assessment for either old or new debt but could be for current expenditures as with the property tax.

If traditional special assessments were meant to be banned by Proposition 13, it is a dumb idea. Suppose you want some new street lights in front of your house? You and your neighbors can now get together and have them put in by the city. The city can borrow money to finance them on a tax exempt basis and pass on the saving to you. If you did it privately, the money to finance the lights would have to be borrowed on the private market. If borrowing on the private market were an economic advantage, the U.S. Chamber of Commerce would not be in favor of industrial development revenue bonds which essentially do for business what a special assessment technique can do for homeowners—lower costs. Of course, Proposition 13 is not concerned about lowering costs; it is only concerned about lowering taxes.

Supporters of Proposition 13-like initiatives may by this point believe that these proposals to replace property taxes with taxes on property are legally viable. There is a strong possibility that the limit imposed on real property taxes could be avoided. They will now bring up the big artillery in the form of Section 3 of Proposition 13 to prevent the proposed alternatives from being adopted.

> . . . 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. . . .

There are several legal ways around that provision. The easiest evasion is to have the state enable local governments to enact taxes. A state-enabled local tax is not a state tax. Another possibility is for the legislature to state a purpose other than increasing revenues. Suppose the legislature increases the tax on cigarettes and states that the purpose is to improve our health? Or a tax on gasoline with the purpose of lowering pollution? The revenue increase would then be incidental. The real purpose would be to improve health or lower pollution. Courts have upheld legislatures in similar situations in the past.[30]

What is an "increased rate or change . . . in methods of computation?" Suppose the legislature decides to impose a sales tax on services as well as on sales of tangible personal property? Surely it is open to argument that an increase in the tax base is neither an increase in rate nor a change in the method of computation of the sales tax. Finally, of course, if Proposition 13-induced shortfalls are bad enough, a two-thirds vote of each house of the legislature is a distinct possibility. The budget of some states is now passed by such a majority. If that can routinely occur, why would one suppose that the taxes necessary to finance the budget could not be similarly obtained?

The supporters of Proposition 13-like initiatives are now down to their last lines of defense. Section 4 of proposition 13 provides that:

> 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.

This provision would not preclude the adoption of the proposals. First, school districts are not covered so the proposed taxes on property could be authorized for and by them. Second, while a two-thirds vote can impose taxes, that is not stated as the only way that taxes can be imposed. There may be other ways. City charters in some states can authorize imposition. A state legislature can authorize imposition. The state is not barred from enabling local taxes.

What is a special tax? Does that mean "new" or "additional" tax? Suppose local sales tax rates are increased? Is an increase in rate of taxes already authorized a special tax? "Cities, Counties and special districts . . . may impose . . . taxes on such district." It is true, districts do own property. Does Section 4 merely permit cities and counties and districts to tax the property owned by special districts?

CONCLUSION

Property tax limits based on the Proposition 13 model have all the legal tenacity of soft yogurt. For those who wish to limit government taxation or expenditure, the Proposition 13 model is a delusion in the long term. There are a number of other types of limitations now being proposed. The second generation may be a better vehicle to limit government grown too wasteful for the public taste.

REFERENCES

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2. *Final Report of the County Formation Commission for the Proposed South Bay County 27* (March 24, 1978).
3. J. Kendrick, *The National Wealth of the United States* (March 1976), table 2-2.
4. Total property taxes in 1974-75 were $51.49 billion and in 1975-76, $57 billion, about $6 billion more. See U.S. Bureau of the Census, *Governmental Finances 1974-75,* table 17; *id.,* 1975-76. Adding $12 billion for two years to 1975-76 equals $69 billion estimated for 1977-78.
5. U.S. Bureau of the Census, *Statistical Abstract of the United States 1977,* table 703.
6. California Assembly Revenue and Taxation Committee, *Facts About Proposition 13—The Jarvis/Gann Initiative* (Feb. 15, 1978), app. 8.
7. Property taxes in Oregon were $633.8 million in 1974-75 and $775.4 million in 1975-76, an increase of $141.6 million. See U.S. Bureau of the Census, *Governmental Finances in 1974-75,* table 17; *id.* 1975-76. Assuming an equal increase in the next two years, taxes now must be about $1.0586 billion.
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16. *Ibid.,* sec. 8; California Revenue and Taxation Code, sec. 401.4.
17. *Ibid.,* sec. 8; California Revenue and Taxation Code, sec. 439.
18. *Supra,* note 11.
19. *Waxenberg v. Commissioner,* 62 T.C. 495 (1974); Rev. Rul. 1973-2 C.B. 47.
20. Freeman, Stevenson, and Cressy, "The State Action Alternative for Changing the Federal Income Tax Incentives Balance Between Homeownership and Rental," 5 *Journal of Real Estate Taxation* 224 (1978); Kee and Moan, "The Property Tax and Tenant Equality," 89 *Harvard Law Review* 531 (1976); Marcuse, "The McKinsey Report: Toward a New Deal for Renters" (New York: Nov. 13, 1972), p. 118.
21. *Supra,* note 20.
22. Telephone interview Aug. 15, 1978 by author with Paul Moore, staff, Ways and Means Committee, State Assembly, Albany, New York.
23. Forty-five states have income taxes. See *All States Tax Handbook* (Prentice Hall, 1977), p. 210.
24. Hagman, "Special Capital and Real Estate Windfall Taxes," *Windfall for Wipeouts: Land Value Capture and Compensation,* ed. Hagman and D. Misczynski (1978).
25. Forty-six states have sales taxes. See *All States Tax Handbook* (Prentice Hall, 1977), p. 210.
26. *City of San Diego v. Linda Vista Irrigation Dist.,* 108 Cal. 189, 41 P. 291 (1895).
27. *California Water Code,* sec. 41323.
28. *Ibid.,* sec. 31703.1.
29. *U.S. Treasury Regulations,* sec. 1.164-4(b) (1).
30. See *e.g., Railway Express Agency v. Virginia,* 358 U.S. 434 (1959); "the use of magic words or labels" can be decisive.