

## California's Proposition 15 to impact owners of non-exempt commercial and industrial real estate

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Since the enactment of Proposition 13 ("Prop 13") in 1978, California has taxed property on a "one size fits all" basis, that is, all property whether commercial, industrial, residential, mixed-use, or agricultural, is assessed annually at an ad valorem tax rate of 1% of the "full cash value" of real property (this rate excludes local taxes). "Full cash value" (hereafter referred to as "base year value") generally means the fair market value when the property is purchased, newly constructed, or undergoes a change of ownership. Each year thereafter, the base year value may be adjusted by a maximum increase of no more than 2% per year, irrespective of the fact that the fair market value may have substantially increased. Finally, the property is not subject to reassessment until a change of ownership. Prop 13 thus allows a longstanding owner to enjoy low property taxes, even if such property is highly appreciated.

Proposition 15 ("Prop 15") would fundamentally change Prop 13 by creating "splitting" the tax roll, which would allow more frequent reassessment of commercial, industrial, and portions of mixed-use properties, but leaving unchanged, current taxation rules for residential and most likely agricultural properties. Additional details as to the proposed law are as follows:

- **Periodic Reassessment of Commercial, Industrial, and Mixed-Use Properties:** All commercial and industrial properties would be reassessed no less than once every three years. In the case of mixed-use property, only the proportion used for commercial or industrial purposes would be subject to reassessment (though there is a possibility that if 75% or more of the mixed-use property by square footage or value is residential, then such property may be excluded from reassessment). In contrast, residential properties (i.e., single- and multi-family homes, and apartment buildings) and agricultural properties will continue to be taxed under current law.
- **Small Business Properties May Qualify for an Exclusion from Reassessment, But There's a Catch:** In order to protect small businesses, commercial and industrial properties would be excluded from frequent reassessment so long as the fair market value of such property is equal to or less than \$3,000,000. In such cases, so long as the value is equal to or less than \$3,000,000, current law would continue to apply (subject to a change of ownership). However, the small business exclusion would not apply if any of the "*direct or indirect beneficial owners of such property own a direct or indirect beneficial ownership interest*" in other commercial or industrial property in California, and all such ownership interests, in the aggregate, exceeds a fair market value of \$3,000,000. The Legislature has not yet determined how such direct or indirect beneficial ownership is to be determined, but based on the broad language used, ownership through the medium of trusts, legal entities, and leasehold interests, in addition to direct ownership, could count towards the aggregate.
- **Phase-In Implementation, Deferral Options for Small Businesses:** If Prop 15 is passed, reassessment would be phased-in (at a yet-to-be-determined percentage) beginning with 2022-2023 fiscal year. The phase-in is necessary to allow reasonable implementation at state and local levels, and to ease the burden of payment at the taxpayer level. In addition, if commercial or industrial properties are occupied by a majority as measured by square footage of qualifying "small businesses" such properties could delay the onset of reassessment mandates until 2025-2026 fiscal year.
- **New Tax Exemptions for Business Equipment:** In contrast with current law, Prop 15 would provide an exemption of up to \$500,000 of all tangible personal property owned and used for business purposes. For qualifying "small businesses", the exemption would be unlimited.

### Planning Actions to Consider

By design, Prop 15 does not contain all of the requisite statutory and regulatory details needed to implement the changes, rather, it delegates that job to a task force comprised of state, local, and other interested constituents. This does not mean however, that it is too early to plan for these potential changes if Prop 15 is passed. Actions that you may wish to consider now, include:

- **Lease Agreements:**\* If you are a landlord or a tenant with a current or prospective interest in commercial or industrial property, consider reviewing the terms of the relevant lease agreement to determine which party is responsible for tax increases due to a reassessment. If the lease agreement will be renewed prior to the potential tax increase, those negotiations should incorporate Prop 15 protection or limitation, depending on the tax liability.
- **Small Business Property Exclusion from Reassessment:** If you own commercial or industrial property and you intend to qualify for the small business property exclusion, consider reviewing whether your other assets or investments could push you over the \$3,000,000 fair market value aggregate threshold, and render the exclusion unavailable. To avoid that future result, you may wish to consider selecting non-commercial or non-industrial property asset classes.
- **Mixed-Use Property Exclusion from Reassessment:** If you own or are constructing a mixed-use project, consider whether your property or project satisfies the 75% residential allocation threshold (by square footage) to qualify for the Prop 15 exclusion from reassessment. Minor amendments to the property or project now, prior to the enactment of Prop 15 (if applicable) may result in long-term tax savings.
- **Small Business Reassessment Deferral:** If you own commercial or industrial property and you intend to take advantage of the Prop 15 deferral from reassessment until 2025-2026 fiscal year (and possibly beyond), you will need to certify that 50% or more of the occupied space in your property is occupied by qualifying small businesses no later than the 2022-2023 fiscal year. Therefore, your present tenant decisions should incorporate and be informed by Prop 15's requirements.

## Withers Assistance

If Prop 15 passes, the regular reassessment across all non-exempt commercial and industrial properties will represent the largest property tax increase to Californians in the last 40 years. Owners of such properties are advised to proactively plan for such increases now, and Withers can provide guidance as the statutory and regulatory rules are developed. The above are some examples of planning issues and options to consider, and there are others. Each situation is unique and Withers real estate counsel would be pleased to advise on the planning options. Please contact Mr. W. Stephen Wilson at (415) 872-3212 or Mr. Yin T. Ho at (415) 872-3232 with any questions or to discuss specific options.


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