

# ANALYSIS OF ORIGINAL BILL

Author: Cannella Analyst: Jane Raboy Bill Number: SB 537  
 See Legislative  
 Related Bills: History Telephone: 845-5718 Introduced Date: February 26, 2015  
 Attorney: Bruce Langston Sponsor \_\_\_\_\_

<b>SUBJECT:</b>	Real Property Tax Bill Amounts Paid Deduction
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## SUMMARY

This bill, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), would allow a deduction for all amounts included in a real property tax bill.

## RECOMMENDATION

No position.

## REASON FOR THE BILL

The reason for this bill is to provide tax relief by clarifying that any real property tax payments paid would be deductible on a state income or franchise tax return.

## EFFECTIVE/OPERATIVE DATE

This bill would be effective upon enactment and specifically operative for taxable years beginning on or after January 1, 2015.

## FEDERAL/STATE LAW

Existing federal and state laws generally allow a taxpayer to deduct any state, local, or foreign real property taxes imposed on property owned by the taxpayer and paid or accrued by the taxpayer during the taxable year. Individuals are allowed to deduct from their adjusted gross income (AGI) either a fixed amount (indexed for inflation), known as the standard deduction, or the amount of a taxpayer's itemized deductions, whichever is greater. Certain expenses, such as property taxes, medical expenses, charitable contributions, interest, and taxes, are deductible as itemized deductions.

However, unless specifically provided, a deduction qualifies as a miscellaneous<sup>1</sup> itemized deduction and is allowed only to the extent that the aggregate of the deduction exceeds 2 percent of the AGI.

Additionally, federal and state law generally allow a taxpayer engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business, unless specifically excluded by statute.

<sup>1</sup> See Revenue and Taxation Code section 17076(b).

Board Position:	Executive Officer	Date
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## **THIS BILL**

This bill would allow an itemized deduction under the PITL, and alternatively a deduction under the CTL, for the amount paid by the taxpayer for the amount due on the taxpayer's real property tax bill, including, but not limited to, real property taxes, personal property taxes, special taxes, special assessments, fees, or other charges.

## **IMPLEMENTATION CONSIDERATIONS**

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

The deduction allowed by this bill, under PITL, for otherwise non-deductible taxes, assessments, fees, and other charges would be treated as a miscellaneous itemized deduction and allowed only to the extent that the aggregate of the deduction exceeds 2 percent of the AGI. If this is contrary to the author's intent, the bill should be amended.

## **TECHNICAL CONSIDERATIONS**

The phrase "personal property taxes" on page 2, line 27, is unnecessary and should be deleted because "personal property taxes" would be excluded from an amount due on a real property tax bill.

This bill should specify that the itemized deduction under the PITL, and alternatively a deduction under the CTL, applies to the amounts either "paid or incurred," thus providing for both cash-basis and accrual-basis accounting methods.

## **LEGISLATIVE HISTORY**

AB 893 (Day, 2013/2014), would have allowed a deduction on a state return for Mello-Roos Community Facilities Fees. AB 893 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline

AB 1552 (Silva, 2011/2012), substantially similar to this bill, would have allowed any amount paid by a taxpayer that is shown on their property tax bill as a deduction on the state return. AB 1552 failed to pass out of the Assembly Revenue and Taxation Committee.

## **PROGRAM BACKGROUND**

California's property tax bill consists of many taxes and charges including the taxes based on property value (1 percent rate<sup>2</sup> and voter-approved debt rates) and other taxes and charges (such as, assessments, parcel taxes, garbage, water, sewer, and Mello Roos taxes).<sup>3</sup>

<sup>2</sup> The 1 percent rate was established by Proposition 13 (1978).

<sup>3</sup> See "Understanding California's Property Taxes," from the Legislative Analyst's Office, dated November 29, 2012, at < <http://www.lao.ca.gov/Publications/Detail/2670>>

The types of charges that appear on property tax bills, however, are not uniform across the counties in California. As such, some counties can have items, such as water and garbage, on their property tax bills, while other counties bill taxpayers directly for these services.

### **Taxes Based on Property Value**

Levies based on value, such as the 1 percent rate and voter-approved debt rates are known as "ad valorem taxes". The property taxes are usually identified on a property tax bill as an amount that includes a tax rate percentage.

### **Other Taxes and Charges**

Generally, a taxpayer may not deduct any assessment, charge, or special assessment for local benefits (such as streets, sidewalks, and other like improvements) of a kind tending to increase the value of the property assessed that are imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, unless the assessment or charge is made for the purpose of maintenance or repair, or for the purpose of meeting interest charges with respect to those local benefits.

An assessment, charge, or special assessment for local benefits is usually identified on a property tax bill as an amount that does not include a tax rate percentage. These assessments may include, but are not limited to, the following:

- Parcel taxes, fees, and charges
- Lighting and landscaping maintenance
- 1915 Assessment District Bonds
- Water, garbage collection, mosquito abatement, urban runoff, park safety, lead abatement, sewer, and flood
- Police and fire services
- Libraries
- Mello-Roos Community Facilities Districts

In 1982, the California Legislature enacted the Mello-Roos Community Facilities Act. The Act allows any county, city, special district, school district or joint powers authority to establish a "Community Facilities District" (District) which allows for the financing of public services and facilities. Mello-Roos Fees can be for both specific benefits and for things that benefit other property owners as well. For example, services for the general public welfare include police and fire protection, streets, schools, parks, and libraries. A District is authorized to sell tax-exempt bonds to fund such local improvements and then assess a special tax (Mello-Roos Fees tax) against property within the District to repay the bonds. Typically, the property that is assessed is one of the properties that receive the benefits, either through use of services and facilities or increases in property value. This type of tax is distinguished from regular real property taxes that are levied purely for the general public welfare and at the same (ad valorem) rates on all properties within the jurisdiction. The Mello-Roos Fees tax is usually included on the annual County property tax bill sent to taxpayers.

All or a portion of California Mello-Roos and other assessments may be deductible as real property taxes even though the Mello-Roos Fee is not imposed on an ad valorem basis.<sup>4</sup> Specifically, assessments on real property owners, based other than on the assessed value of the property, may be deductible if they are levied for the general public welfare by a proper taxing authority at a like rate on owners of all properties in the taxing authority's jurisdiction, and if the assessments are not for local benefits (unless for maintenance or interest charges).

## **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

*Florida* allows for a corporate income tax deduction based on the ad valorem property taxes paid or incurred; this is the same basis from which the California property tax deduction is determined. *Florida* does not impose a personal income tax.

*Illinois, Michigan, Minnesota and New York* allow for a credit or a deduction for corporations and individuals based on the ad valorem property taxes paid or incurred without the inclusion of special assessments paid or incurred; this is the same basis from which the California property tax deduction is determined. In addition, *Illinois* requires a personal income taxpayer to provide the parcel number of the real property for which the ad valorem tax was paid or incurred in order to be eligible for the property tax credit.

*Massachusetts* allows for a corporate income tax deduction based on the ad valorem property taxes paid or incurred; the same basis from which the California property tax deduction is determined. *Massachusetts* also allows a personal income tax credit that is based on the ad valorem property taxes paid or incurred by the taxpayer as well as a portion of the water and sewer fees paid or incurred by the taxpayer.

## **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

<sup>4</sup> Internal Revenue Service Office of the Chief Counsel in response to a letter from the Franchise Tax Board dated February 6, 2012.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 537 As Introduced February 26, 2015 Assumed Enactment After June 30, 2015 (\$ in Millions)		
2015-16	2016-17	2017-18
- \$3.6	- \$3.8	- \$4.0

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The bill would allow a deduction for otherwise non-deductible assessments and other charges found on a property tax bill. These deductions would be treated as miscellaneous itemized deductions subject to the federal 2 percent AGI limitation.

Based on tax return data, 4.7 million taxpayer returns deducted \$24 billion in real estate taxes in 2012. An internal review of property tax bills throughout the state and a 2009 GAO report on real estate deductions indicate approximately 70 percent of returns claiming the real estate deduction would increase deductions by an average of \$940 per return if otherwise non-deductible items on real property tax bills were deductible. This would result in an estimated \$3.1 billion of additional deductions claimed on personal income tax returns.

Modeling the estimated average \$940 deduction increase and applying the 2 percent federal AGI limitation results in increased taxpayer real estate deductions of \$49 million in 2012. This amount is indexed using Department of Finance forecasts to \$58 million in 2015 and results in a tax liability decrease of \$3.6 million after applying a 6 percent average tax rate.

No revenue loss is anticipated for corporate taxpayers because it was assumed for federal and state purposes corporate taxpayers can deduct their property tax payments as an ordinary and necessary expense in conducting that trade or business.

The tax year estimates are converted to fiscal years and rounded to arrive at the amounts reflected in the table above.

### SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Proponents: Some may argue that this bill would provide equitable treatment for Mello-Roos Community Facility Fees assessed on real property owners.

Opponents: Some may argue that this bill would allow deductions for expenses that benefit individual property owners rather than the general community.

## **POLICY CONCERNS**

This bill would create differences between federal and California tax law, requiring taxpayers to calculate different deduction amounts for the federal and state income tax returns, thereby increasing the complexity of California tax return preparation.

Many county real property tax bills contain non-tax fees for services such as garbage collection, water, sewage. This bill would create inequitable tax treatment between taxpayers living in counties that collect non-tax service fees through the real property tax bill and those taxpayers living in counties that collect the fees through a bill separate from the real property tax bill.

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