“As-Was” Property Taxes in the State of Alaska

SUMMARY

Economic development, growth and government efficiency are key goals of most boroughs and municipalities in Alaska including those that levy a property tax.

The premise of this white paper is that the current practice within the state to <u>annually</u> assess property tax on the full and true value of real property and improvements is a disincentive to economic development and community growth due to increased costs of ownership. It is an expensive use of government manpower, adds a subjective element (assessment) into the taxation process, and there are more efficient ways to value and tax property.

PDR Alaska proposes that property be taxed “As-Was”, or in other words, at the price when title last changed hands. That value remains fixed and the value of any improvements to the property are captured and added to the tax base only when the property is subsequently sold to someone else and the tax assessment is reset at that time. Thus, the taxing authority locks in its assessed value (and may adjust that value for inflation) but any and all subsequent improvements remain tax free until sold. To implement the plan, a baseline would be determined as of a given date, say, January 1, 2016, that would serve to “lock in” the starting values for “as-was” assessment. To perfect this system of valuation, all sales of real property within the taxing jurisdiction would require, by law, reporting of the sale price to determine a new “As-Was” upon transfer of title. The new owner could easily project his future cost of ownership based on the sales price knowing that it was locked in until he sold the underlying property (or used it commercially). As a caveat to prevent fraud or abuse, sales to related parties would be recorded at the new sales price or the existing As-Was value, whichever was greater.

A side benefit of this approach is that it makes assessment much easier and cost effective. It simply becomes an effort to record the base value for all properties within the tax jurisdiction and then track their sales prices over time. The aggregate value of properties sold (reported prices) for any year could be used to determine the local inflation rate of all property and the tax base adjusted timely and uniformly. There would be no reason to do any field work thus saving potentially thousands in costs that could help offset any perceived “loss” of tax revenue from the “As-Is” value adjustment under the current system. A Board of Equalization would be moot.

A change to an “As-Was” taxable value based on the purchase price to any given owner also makes more sense from the standpoint of predictability, fairness, accuracy, and as an incentive to increase economic development by enhancing or accelerating local investment in real estate development.

A final caveat to this approach: when Prop 13 was instituted in California many years ago, it overlooked the fact that commercial properties change hands rather infrequently. Also, since most commercial entities are perpetual in nature (only the shareholders or members change over time), title in real property for commercial real estate is fairly static thus there is no adjustment to the tax base over time. This actually acts as a disincentive to selling property due to the increase in taxes a new owner may experience and creative methods have been developed to avoid a change in ownership while allowing a change in use, for example capital leases.

This Alaska proposal has an adjustment for inflation built into it that mitigates the problem somewhat, though it does not necessarily capture the market effect for commercial property. Therefore, commercial properties are partially excluded from the “As-Was” methodology. A property will have the base value locked in at the purchase price until it changes hands <u>or begins to generate revenue for the owner</u>. Any property that generates income would remain subject to annual full value assessment.

Discussion:

Currently, most tax authorities use a mass appraisal approach to value real property at its true and full value annually as required by state law. Actual improvements to real property are usually physically inspected and assessed during a three to four year review cycle and the value is added to the value of the property. Thus, any improvements made to the property increase the ongoing costs of ownership, specifically increased property tax, which is further subject to inflation. With a fully applied mil rate, this increased cost can be anywhere from .5% to 1.5% of the value of the property annually, and while not insurmountable, it certainly creates a challenge to income production or simply raises the cost of living in Alaska. Often, improvements to property become the basis for disputes over the assessed value of a given property.

On the other hand, if the value of such improvements was not added to the taxable base until the property was sold; there would be no financial penalty in converting cash to hard assets. The value of any improvements would be captured later on as part of the selling price in an arms-length transaction between, in most cases, a willing buyer and seller in the marketplace. Increased development of raw land as well as major renovations would be encouraged since large investments of precious cash would not subject the property owner to added and ongoing property tax expenses that they would not endure by simply keeping their cash in the bank. The taxing authority would eventually receive the added tax base and revenue when the owner actually recognized a gain or loss on the capital investment but only when and if the improved property was converted back to cash (or began to generate income). At that time, the new owner, who established a market value on the property through the sale would be assessed the sale price and begin paying the tax on it. But in the case of the new owner, he would know the exact starting value to be used to compute all future taxes subject to simple inflation, not annual re-assessment.

The increase in property tax revenue to the taxing authority due to owner improvements year over year is relatively minor. It is only a fraction of the increased value in the tax base, the lion's share of year over year tax base increase usually being due to inflation and new construction. Inflation has been accounted for under this As-Was method and new construction is actually encouraged when there is no long term tax penalty. Also, there is a lot of cost involved in assessing the added value and adjudicating disputed values. The As-Was method eliminates all of the guesswork from non-commercial properties since the original cost of the property is already in the tax base.

While hard to quantify, elimination of the investment disincentive should also increase local economic activity and the added sales tax, employment, and local commerce should partially offset the loss of "as-is" taxes.

It is an interesting observation that many folks delay an investment in home improvements, especially to the exterior where the assessor has unfettered access, until right before they sell rather than right after they buy a home. In doing so, they actually forego the enjoyment of the improvement to avoid paying higher taxes during ownership.

Reasoning:

Under "as-is" taxation, any and all increases in the value of the underlying property are estimated and taxed, so it costs less and is more logical for an owner to just leave his cash in the bank earning interest rather than convert cash to taxable assets. While not an overriding consideration (often there are other reasons to add on to property), all other things being equal, a prudent person would not create a situation

where he has to pay for an asset, then “rent” that asset by paying increased tax, subject to inflation, every year until it is sold.

For residential properties, this might seem to be a minor issue: adding a deck or a small addition to a home will not seem to increase an owner’s annual taxes much, until we dig into the numbers. If I have a $200,000 house that is taxed at 10 mils ($2,000), adding a $20,000 addition would add $200 per year to my taxes which doesn’t seem much but is actually a 10% annual tax increase and over say a 20-year life of the addition, I will have paid an additional $4,000 in taxes, making my overall cost for the addition increase by 20% to $24,000.

For new residential developments and especially commercial subdivisions, the cost is much more significant. For example, if a developer purchases a lot for say $100,000, he will pay about $1,000 per year until the property is sold, however if he constructs a $200,000 home on this lot, his taxes will increase about $2,000 per year to $3,000 until he sells the house which could take months or years. If that developer is trying to do build a subdivision with multiple dwellings, such as houses or condos, the cost is vastly multiplied and will likely continue for a longer period of time until he finds buyers. In absolute dollars, this could be tens of thousands and a much larger disincentive to investing and developing.

Most bankers and other lenders will opine that increasing the expenses associated with property creates a burden that drives down the values upon which they base collateral and loans. Most experts also agree that consistent property values are an important underpinning of a healthy local economy. For lenders, it is very important that property values at least remain stable or gradually rise at a pace that is sustainable. As an owner or investor it is very important to be able to adjust revenue sources equitably where the market allows as expenses increase.

The ability of a commercial property to generate cash flow (simple application of revenues and expense calculations) often is used to calculate the appraised market value. An increase in expenses can have a dramatic effect on the market value of any subject property.

Analysis:

What is proposed here is very similar to California’s Proposition 13, which was a citizen’s referendum that modified the California constitution in 1975. Basically, California limited their real estate tax not to exceed 1% of the full cash value of the property. But additionally, the proposition assessed property values at their 1975 value and restricted annual increases of assessed value to an inflation factor, not to exceed 2% per year. It also prohibited reassessment of a new base year value except for in cases of (a) a change in ownership, or (b) completion of new construction. It also contained language requiring a two thirds majority for future increases of state or local tax rates. One of the prevailing reasons for Prop 13 was that older Californians should not be priced out of their homes through high taxes.

Prop 13 was considered to have possible deleterious effects on the housing market since property owners would keep and modify property or transfer it to a family member to avoid a new, higher assessment. While our proposal is similar regarding transfers to related parties, it does not propose a cap on inflation at 2%. Not limiting the inflation factor tends to mitigate the fact that the base assessment is locked in until the property is sold. Since California capped inflation increases in the assessed value of property at 2% per year, and that rate did not keep up with actual real estate inflation, a disincentive to sell was created between market value and assessed value. In our proposal, only added improvements to the property are excluded from the assessed taxable value and calculated, local, actual inflation is applied to the base value determined at purchase.

Also, in contrast to the California proposition, under As-Was, new construction is considered an improvement and not subject to tax assessment unless and until it generates income, thus a homeowner who built a new home on a previously undeveloped lot or did a major renovation/reconstruction effort to a pre-existing property would have a larger incentive to defer capital gains by holding onto that property and not reselling. This would lead to enhanced population stability. On the other hand, a developer would not be penalized by increased taxes until the first sale of the developed/redeveloped property or it began producing income.

Also under our proposal, since all real estate transactions would be required to be reported, the inflation calculation would be based on actual real estate transactions in the local market that should more closely track actual property values over time as opposed to a broader, estimated inflation index. Thus large bubbles and/or deficits in unrealized property value are less likely to impede the real estate market velocity.

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