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July 22, 2014

Dear Clerk of the Board of Supervisors:

Please deliver the enclosed letters to Board President Chiu and the other Boardmembers.

Thank you.

Paula Scott

Paula Scott
Assistant to James R. Parrinello

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July 22, 2014

Dennis Herrera, Esq.
City Attorney
City and County of San Francisco
Office of the City Attorney
City Hall, Room 234
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102-4682

RE: Proposed Initiative Ordinance Imposing a General Tax on Sales of Certain Real Property Held Less than Five Years.

Dear Mr. Herrera:

We are writing to you on behalf of our clients, the San Francisco Apartment Association and the Coalition for Better Housing, concerning the proposal by Supervisor Mar to impose a new tax on sales or other transfers of certain types of residential real property where that property had been purchased by the seller or transferor fewer than 5 years prior.

As set forth below, the proposed initiative ordinance (the "Tax Ordinance") violates Article XIIID, §4 of the California Constitution, because it is a "tax. . . upon a parcel of property or upon any person as an incident of property ownership" but is *not* drafted as a "special" tax which would require "a two-thirds vote pursuant to Section 4 of Article XIIIA" to be validly enacted. As such, placing the measure on the November, 2014 general election ballot would be a fruitless act.

Provisions of the Tax Ordinance

Although the Tax Ordinance is labeled as an extension of San Francisco's established documentary transfer tax ("DTT"), the nature of a tax is determined not by its labels, but its incidents. (*Flynn v. City and County of San Francisco* (1943) 18 Cal.2d 210; *Ingalls v. Riley* (1936) 5 Cal.2d 154; *Weekes v. City of Oakland* (1978) 21 Cal.3d 386.) A general overview of the Tax Ordinance is a logical starting point.

Rate and Tax Base

As a general matter, the proposed tax is fashioned as a "surtax" to the established Documentary Transfer Tax (DTT); however, it differs significantly in both tax rate and

tax base. The proposed tax is imposed at a graduated rate ranging from 24% of the consideration or value if sold one year or less after acquisition, to 0% if the property were held greater than 5 years since last conveyed.[1] As the measure of tax includes amounts for existing liens and encumbrances),[2] it is akin to a gross receipts tax which shares many characteristics with a sales and use tax on certain types of retail property. This tax is in addition to the existing DTT on real property transactions.[3]

The tax base are sales or other transfers of "residential lands, tenements, or other realty sold within the City and County of San Francisco,"[4] subject to a number of "exemptions," some of which are in existing law[5] and some of which are particular to the proposed tax, which include, but are not limited to:

- Sales or transfers that occur within one year of death of owner of at least 20% of the property sold.[6]
- Sales or transfers of property that is low-income housing, if that is at least a 15-year restriction at time of transfer, or was extended for at least 20 years as part of transfer.[7]
- Sales or transfers of single family residences, as defined.[8]
- Sales or transfers or "new housing" as defined.[9]
- Sales or transfers of a property that was the principal place of residence of a minimum 10% owner for at least one year prior to sale, subject to a list of conditions precedent.[10]
- Sales or transfers of property containing more than 30+ separate residential units.[11]
- Sales or transfers of property containing two or less units if:
    - A building permit was applied for on or before 7/1/14;

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[1] Proposed section 1102(b).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] Sec. 1105(a) and (b).
[6] Sec. 1105(c)(1).
[7] Sec. 1105(c)(2).
[8] Sec. 1105(c)(3).
[9] Sec. 1105(c)(4).
[10] Sec.1105(c)(5).
[11] Sec. 1105(c)(6).

- Total construction cost of the first building permit was at least $500,000; and
- The last building permit was issued within one year preceding the sale or transfer;[12] and

- Sales or transfers of property sold at a loss, with loss determined on second sales price-acquisition price basis (with no adjustment for liens or encumbrances). If a portion of the property sold, determination based on apportionment of square footage.[13]

Other Provisions

Additionally, the Tax Ordinance:

- Authorizes the Board of Supervisors to pass additional exemptions from the tax for properties on which affordability-based occupancy restrictions are placed;[14]
- Apportions the proposed tax on the ratio of square footage sold to total square footage if only a portion of a property exempt from the proposed new tax;[15]
- Excludes from "prior conveyance" sales or transfers which are deeds in lieu of foreclosure, even if the consideration received exceeded the amount owed;[16]
- Is intended to be a "general tax" as defined in Cal. Constitution Art. XIIIC, sec. 1(a), requiring enactment with a majority vote of the electorate;[17]
- Has a severability clause;[18]
- Declares that nothing should be interpreted to create a conflict with state or federal law;[19] and
- Becomes operative January 1, 2015.[20]

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[12] Sec. 1105(c)(7).
[13] Sec. 1105(c)(8).
[14] Sec. 1105(d).
[15] Sec. 1105(e).
[16] Sec. 1102(c).
[17] Nothing in the Tax Ordinance limits the uses of the revenue generated to "specific purposes" (Cal. Const., art. XIIIC, sec. 1(d).
[18] Tax Ordinance, Section 5.
[19] Tax Ordinance, Section 6.
[20] Tax Ordinance, Section 7.

Discussion

The Tax Ordinance imposes a new tax (as opposed to a fee or other type of exaction.[21] As noted above, nothing in the Tax ordinance specifies how the funds generated by the new tax are required to be spent; therefore, they are free to be spent for "general government purposes." Under the Constitution, therefore, the proposed tax is a "general tax."[22]

One difficulty faced by the Tax Ordinance is that it is postured as a "general tax". After the passage of Proposition 218 in November 1996, local governments were severely limited in their options for property-related taxes and fees. The Court of Appeal summarized these limitations succinctly:

> The Fourth Appellate District described the adoption of Proposition 218 as follows" 'Proposition 218 allows only four types of local property taxes: (1) ad valorem property tax; (2) a special tax; (3) an assessment; and (4) a fee or charge. It buttresses Proposition 13's limitations on ad valorem property taxes and special taxes by placing analogous restrictions on assessments, fees and charges' (citation omitted).[23]

Generally speaking the tax proposed in the Tax Ordinance does not fall into any one of these categories.

More specifically, however, Proposition 218 allows a local government to assess a "general tax" on either a "parcel of property or upon any person as an incident of property ownership" only if it is a "special tax" and receives "a two-thirds vote pursuant to section 4 of Article XIIIA."[24] Past precedents *suggest* that the tax proposed in the Tax Ordinance is in fact assessed either on a "parcel of property" or on a "person as an incident of property ownership" and therefore cannot legally be imposed as a general tax.

The leading case on this inquiry is *Apartment Association of Los Angeles County, Inc. v. City of Los Angeles* (2001) 24 Cal.4th 830 ("*Apartment Association*"). In *Apartment Association*, the state Supreme Court upheld a city ordinance imposing a $12.00 per unit inspection fee on private landlords used to "finance the cost of inspection and enforcement by the Housing Department."[25]

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[21] Cal. Const., art. XIIIC, sec. 1(e) (added by Proposition 26 in November, 2010).
[22] Cal. Const., art. XIIIC, sec 1(a).
[23] *Neilson v. City of California City* (2005) 133 Cal.App.4th 1296, 1307.
[24] Cal. Const., art. XIIID, sec 3(a)(2).
[25] *Apartment Association*, at p. 835.

The Court found that the inspection fee fell outside the ambit of Article XIIID, but only because it had certain special qualities. For example, the inspection fee was imposed not on the property owner *per se* but on the property owner as a landlord actively engaged in a "business operation" of renting property, where the fee ended when the business operation of renting property ended.[26] The Court found this distinction critical, stating ". . .it imposes a fee on its subjects by virtue of their ownership of a business---i.e., because they are landlords."[27] The Court called the fee " . . .more in the nature of a fee for a for a business license than a charge against property."[28]

The Supreme Court amplified and clarified this critical distinction:

> In other words, taxes, assessments, fees and charges are subject to the constitutional strictures when they burden landowners *as landowners*. The ordinance [imposing the rental inspection fee] does not do so: it imposes a fee on its subjects *by virtue of their ownership of a business--- i.e. because they are landlords.* [29] (Emphasis added to second phrases.)

The Court also said the inspection fee was permissible because Article XIIID "did not refer to levies linked more indirectly to property ownership."[30] The Court distinguished other incidents more closely associated with the role as owner of the property, most importantly "the fundamental right to alienate one's property held in fee simple."[31]

By contrast, the tax imposed by the Tax Ordinance is not a *de minimis* "regulatory fee"[32] akin to a "business license" but a substantial (and possibly confiscatory) tax on the sale or transfer of real property. It does not "regulate a business;" indeed the tax is due on the sale or transfer of real property within the tax base whether it is currently rented or not. Moreover, even if the property were rented,

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[26] *Apartment Association*, at p.838.
[27] *Id.* at p. 842.
[28] *Id.* at p. 840.
[29] *Id.* at p. 842.
[30] *Id.* at p. 839
[31] *Id.* The Court also called the right to alienate property "inseparable", "indispensible" and "necessary" to ownership and further cited to Bouvier's Law Dictionary's definition of "incident" with approval, there particularly "the right of alienation is necessarily incident to a fee-simple at common law." (*Id.* at footnote 2.)
[32] In the interim since the Supreme Court decided *Apartment Association*, the voters adopted Proposition 26 in November of 2010, which fundamentally changed the analysis of whether an exaction by a local government is a "fee" or a "tax" (Article XIIIC, sec. 1(e)). It is unclear whether the $12.00 fee at issue in *Apartment Association* would be classified as a "charge imposed for . . .reasonable regulatory costs" and therefore not a "tax" (Art. XIIIC, sec 1 (e)(3)).

the proposed tax is not assessed until *after the property is sold and the owner is exiting the business of being a landlord of that property*. Finally, the proposed tax exempts properties with greater than 30 rental units from the tax. With such properties exempt, it is inconceivable to argue that the proposed tax in some way is involved with regulating the business of rental real estate.

Moreover, unlike the fee imposed in *Apartment Association* which that Court characterized as "linked more indirectly to property ownership," the Tax Ordinance imposes a substantial gross receipts tax on that which the Court identified as the most fundamental aspect of property ownership---the right and ability to convey the entire bundle of ownership rights to another person.

The Tax Ordinance also differs in other legally significant ways from the $12.00 inspection fee in *Apartment Association*. The fee in *Apartment Association* was only imposed on "owners of all [rental] buildings subject to inspection;"[33] the Tax Ordinance imposes the new tax on:

> each deed, instrument or writing by which *any residential lands, tenements or other realty sold within the City and County of San Francisco* shall be granted, assigned, transferred or otherwise conveyed to, or vested in the purchaser or purchasers, or any other person or persons...[34] (Emphasis added.)

Even considering the exemptions provided in the Tax Ordinance, the proposed tax program is far more pervasive and all-encompassing than the *de minimus* rental inspection fee approved in *Apartment Association*.

Conclusion

There are other issues associated with the Tax Ordinance which exceed the scope of this letter[35] which also may render it illegal or impractical to impose. But as it relates to the voter approval necessary to impose the proposed tax as currently drafted, we

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[33] *Id.* at p. 835.
[34] Sec. 1102(b).
[35] These include whether the proposed tax is a sales tax on real property which would run afoul of Revenue & Taxation Code section 7203.5, or is confiscatory to the point of being a government "taking."

submit that a two-thirds vote of the electors in the November election would be required, and that the restricted uses of the tax revenue be identified in the Tax Ordinance.

We are happy to meet with you to discuss this letter at your convenience.

Sincerely,

James R. Parrinello

JRP/pas
cc: Hon. Edwin M. Lee, Mayor
Hon. Members, Board of Supervisors