The VLF for Property Tax Swap of 2004
Facts for Local Officials

Rev. Oct 2006

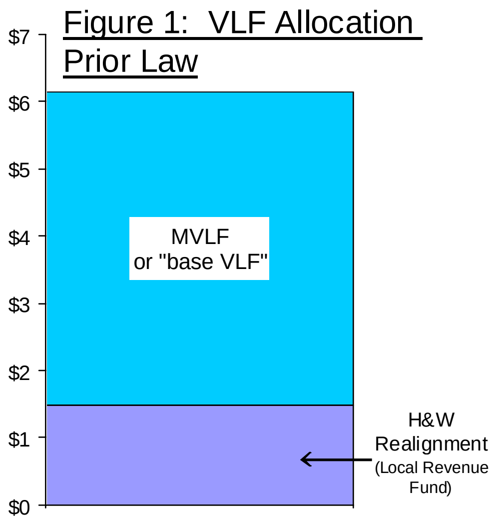
In May 2004, Governor Schwarzenegger proposed a swap of city and county vehicle license fee (motor vehicle in-lieu tax or VLF) revenues for additional property tax share as a part of a state-local budget agreement. The swap was included in the 2004 budget package.

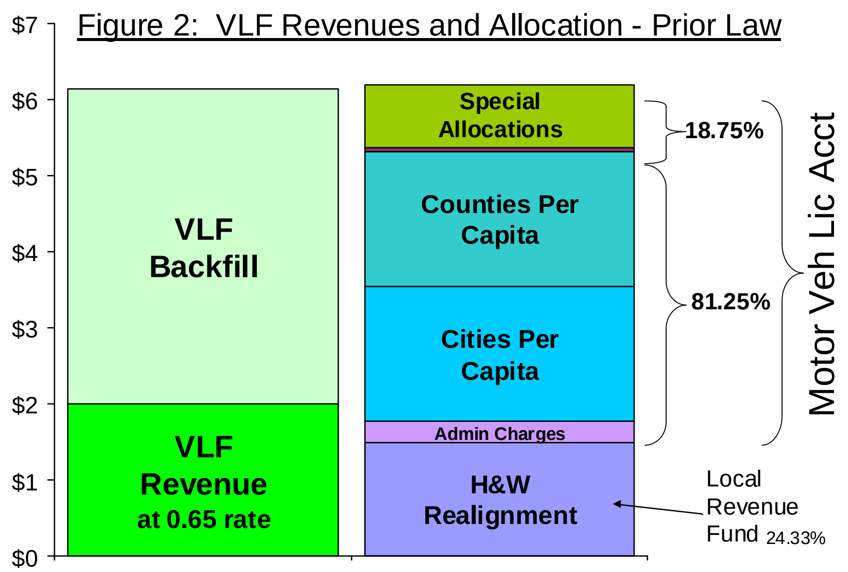
I. The VLF Prior to the 2004 Budget Act

Prior to the 2004 budget act, VLF tax rate was 2% of the value of the vehicle. The state general fund "offset" 67.5% of this tax resulting in an effective tax rate of 0.65%. VLF taxpayer revenues were supplemented with a backfill from the state general fund to provide cities and counties with revenues equivalent to a full 2% VLF tax rate.

Under Section 11001.5 of the Revenue and Taxation Code, 24.33% of VLF funds were allocated to the Local Revenues fund to pay for health and welfare programs largely provided by counties under a state-local program realignment in the early 1990s. Of the remaining amount, about $286 million went to reimburse state agencies for administrative costs of the program (Department of Motor Vehicles, Franchise Tax Board, and State Controller). Of the amount remaining after realignment and administrative charges are taken out, 18.75% was allocated for special payments including supplemental funds for cities that did not levy a property tax in 1977-78, eligible low property tax cities incorporated prior to 1987, and supplemental funds for counties. The 81.25% was allocated half to cities and half counties on a population basis.[1]

Figure 1-2 shows the revenues and allocations of the VLF under the prior law.





[1] For more information on the history and allocation of the VLF see "VLF Facts: A Primer on the Motor Vehicle In-Lieu Tax, the Car Tax Cut and Backfill" and other resources at www.californiacityfinance.com/#VLF

II. VLF-Property Tax Swap of 2004, State General Fund Contribution and Constitutional Amendment

Soon after the LOCAL coalition qualified Proposition 65 for the November ballot, Governor Schwarzenegger proposed that cities, counties, special districts and redevelopment agencies make a two-year contribution to solving the state's budget deficit of $1.3 billion per year. In exchange, the Governor pledged to lead a campaign to secure legislative and voter support in November 2004 for Proposition 1A, a constitutional amendment with important revenue and mandate protections for cities, counties and special districts. The agreement also included the permanent elimination of the Vehicle License Fee backfill and replacement with a like amount of property tax revenue to cities and counties (except for the 2 year state budget contributions). Following negotiations, the legislature passed and the Governor signed a state budget containing these essential elements.

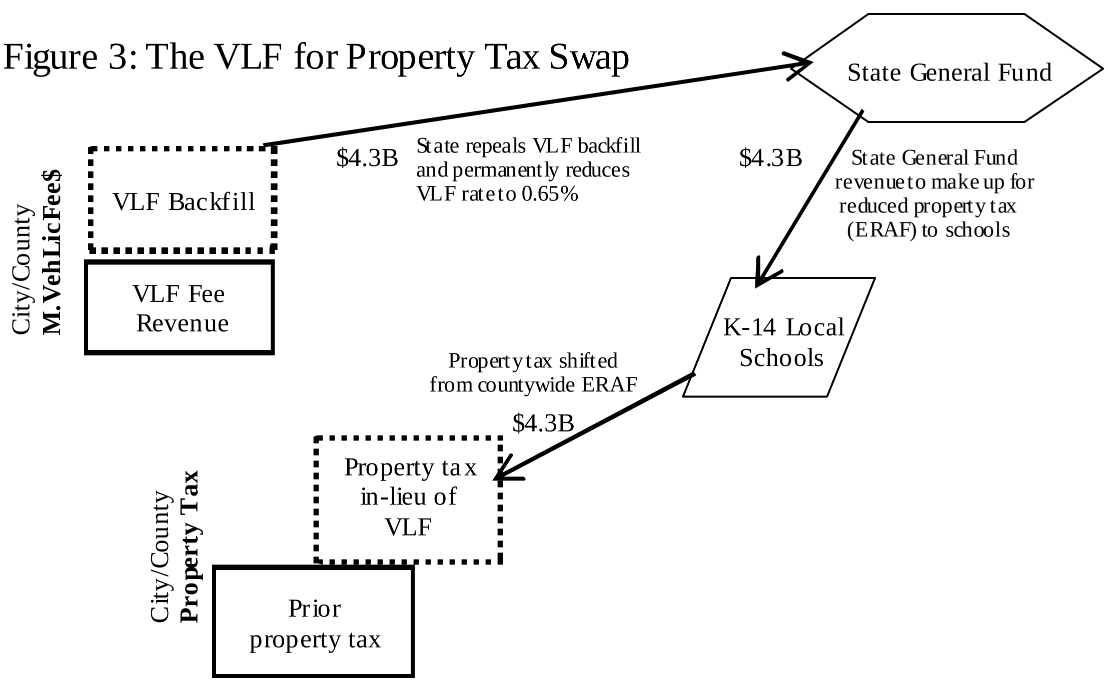
A. Constitutional Amendment.

The legislature placed Proposition 1A on the November 2004 ballot. Proposition 1A was a constitutional amendment that contained similar revenue protection features as Proposition 65 as well as some new features that enhance the level of revenue and mandate protection. Among other provisions, Proposition 1A prohibits the legislature from reducing the additional property tax share provided to cities and counties under the swap of VLF revenue. The measure also requires that the Legislature provide full replacement revenue to cities and counties for any reduction in the 0.65% VLF rate. See *www.CaliforniaCityFinance.com* for more information on Proposition 1A.

B. VLF Reduction Permanent/Additional Property Tax to Cities and Counties.

The 2004 budget included a permanent reduction of the VLF rate from 2% to 0.65% (its current effective rate). The VLF backfill (approximately $4.4 billion) was eliminated and replaced with a like amount of property taxes, dollar-for-dollar. Subsequent to the FY04-05 base year, each city's (and county's) property tax in lieu of VLF or "VLF Adjustment Amount increases annually in proportion to the growth in gross assessed valuation in that jurisdiction.

Figure 3: The VLF for Property Tax Swap

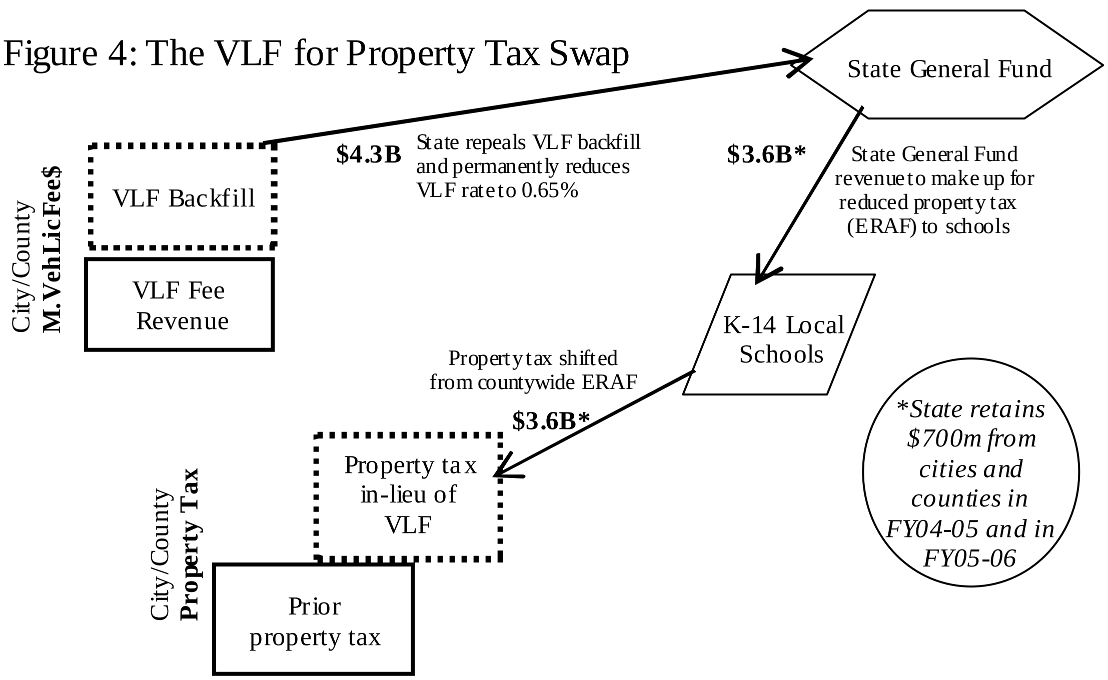


C. Two Year State General Fund Contribution.

In both 2004-05 and 2005-06 cities and counties made contributions to the state general fund of $700 million ($350 million for cities, $350 million for counties). These contributions came from reductions to each agency's "property taxes in lieu of VLF." Redevelopment agencies and special districts also made state general fund contributions in FY04-05 and FY05-06 in the amounts of $250 million and $350 million respectively.

Figure 4 diagrams the VLF for property tax swap taking into account the $700 million contribution from cities and counties in FY04-05 and FY05-06.

Figure 4: The VLF for Property Tax Swap



D. The New VLF Allocation.

Under the new law, the VLF remaining after the repeal of the VLF backfill first goes to maintain full funding of health and welfare programs largely provided by counties under a state-local realignment shift in the early 1990s. In this way the VLF continues to provide the same level of funding for these programs.

Remaining VLF revenue is deposited in the Motor Vehicle License Fee Account. These funds, less administrative charges (largely for the Department of Motor Vehicles) and $54 million (grown annually) in funding for Orange County's debt service, is allocated to cities on a per capita basis.

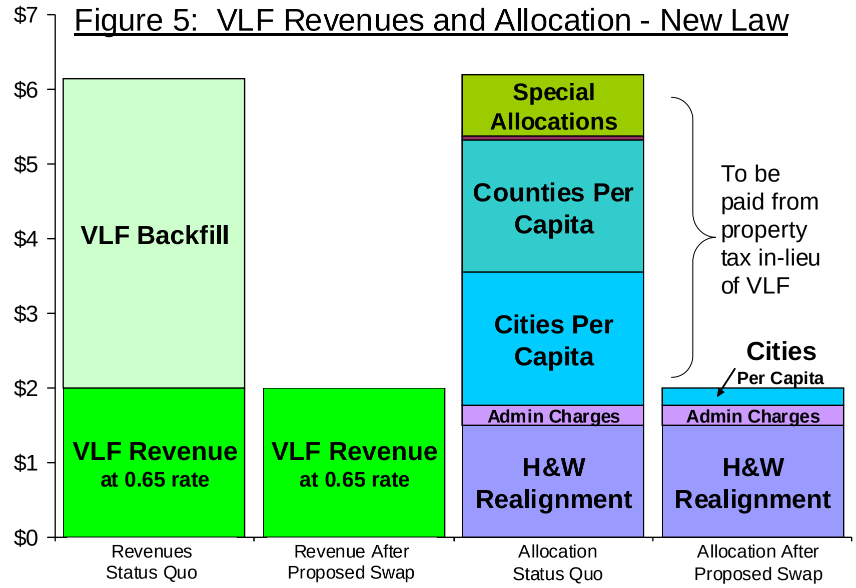
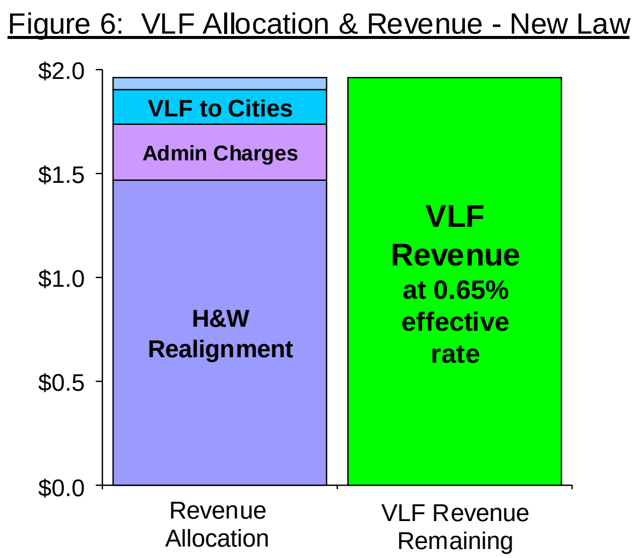


Figure 5 shows the effect of the reduction in VLF backfill and the allocations that were swapped into "property tax in-lieu of VLF." Figure 6 shows the new VLF allocations.



III. City Allocations of VLF and Property Tax In-Lieu of VLF

Figure 7 shows the total VLF allocation to cities under the prior law and the new swap – *before* the state general fund contribution from cities. The remaining VLF to cities under the proposal amounts to less than 10% of city VLF revenue under current law.

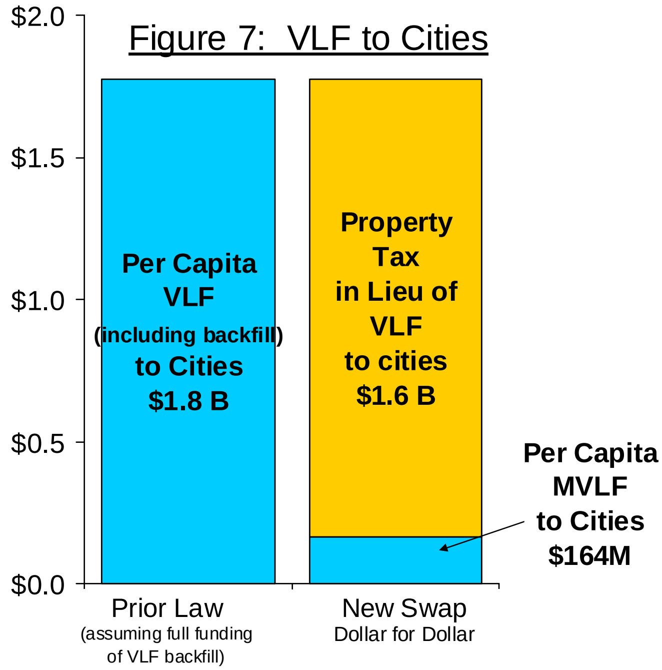


Figure 8 shows how city VLF and "property tax in-lieu of VLF" grows annually. VLF revenues grow as taxpayer VLF revenue to the MVLF account grows. Allocations to individual cities continue to be affected by statewide VLF revenue growth and by each city's population growth relative to the population growth in cities statewide. However, "Property tax in-lieu of VLF" grows in proportion to the growth in each jurisdiction's gross assessed valuation.

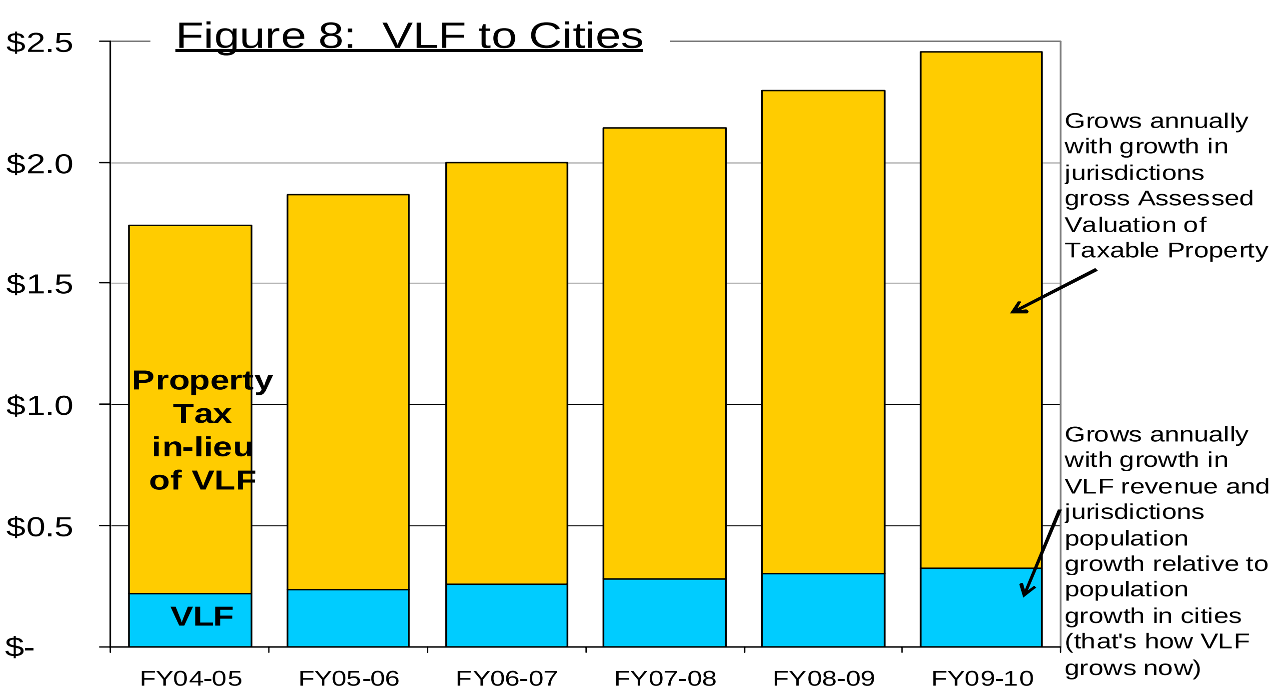
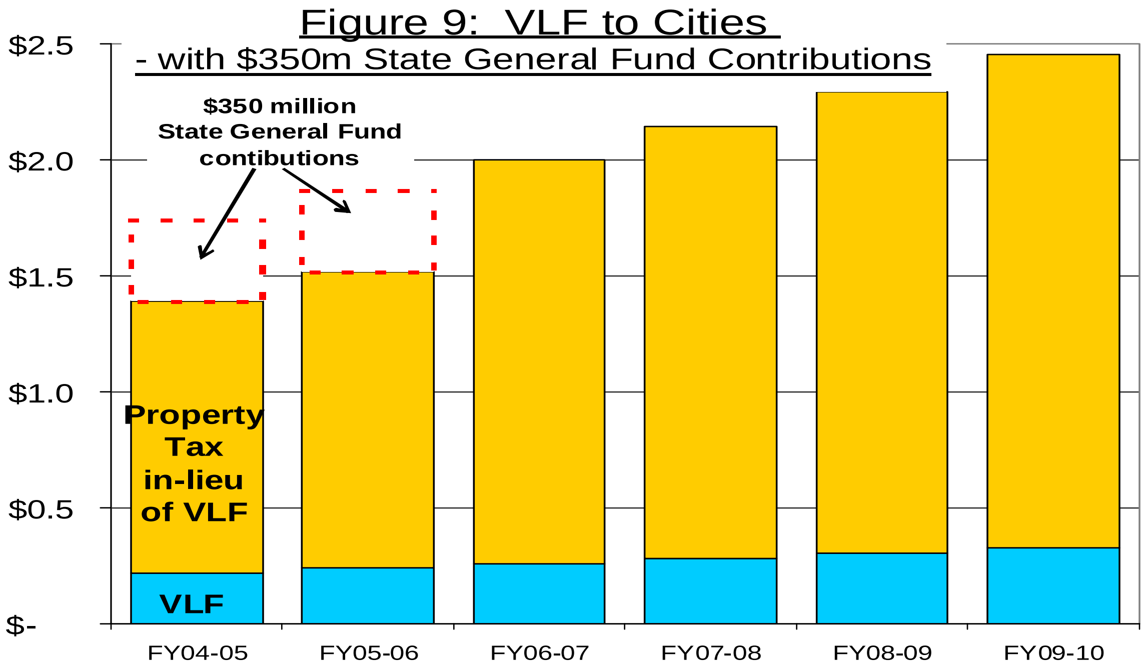


Figure 9 shows the growth in city VLF and "property tax in-lieu of VLF" with the FY04-05 and FY05-06 state general fund contributions.



IV. The VLF - Property Tax Swap and the "Triple Flip."

As a part of the Proposition 57 state fiscal recovery funding mechanism, cities and counties are currently receiving property tax payments in lieu of ¼ cent sales and use tax they would otherwise receive under the Bradley Burns Local Sales and Use tax. The California State Board of Equalization determines the compensation amounts for each city and county. County Auditors make the transfers to each jurisdiction from the countywide ERAF (Education Revenue Augmentation Fund). The state fully compensates school agencies for the reduced ERAF with higher payments from the state general fund. This mechanism is generally referred to as the "triple flip."

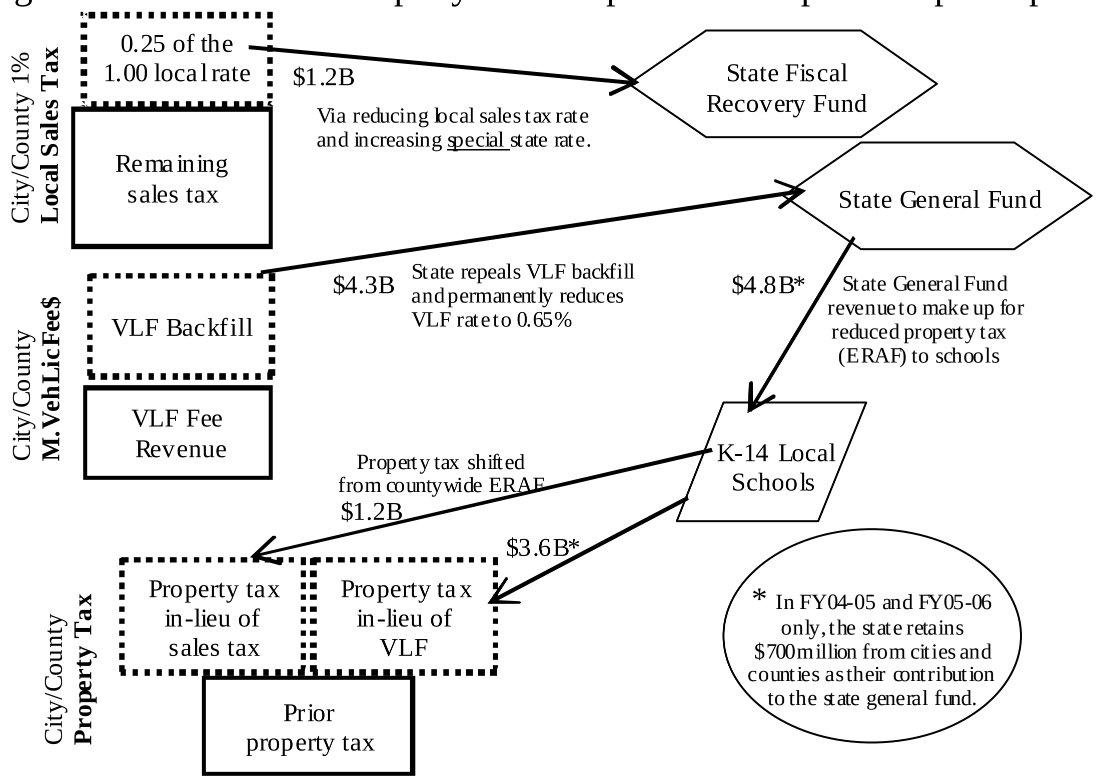
This ***property tax in lieu of sales tax*** operates similar to the way in which the ***property tax in-lieu of VLF*** would work. However, in the case of the in-lieu sales tax payments under the "triple flip," the property tax in lieu of sales tax increases each year in relation to the sales and use tax each jurisdiction would otherwise have received. In effect, year to year growth is in proportion to each jurisdiction's year-to-year growth in sales and use tax revenue. By contrast, the ***property tax in lieu of VLF*** would grow in subsequent years with each jurisdiction's change in the gross assessed value of taxable property.[2]

Because the growth formula is tied to sales tax and because it is temporary, ***property tax in lieu of sales tax*** under the triple flip should be generally be considered a subset of "sales tax revenue". Because it would be permanent and because its growth would be tied to the assessed valuation of real property, ***property tax in lieu of VLF*** should be considered a subset of property tax.

[2] In FY04-05 and FY05-06 the VLF adjustment amounts (property tax in lieu of VLF) were essentially determined by the California State Controller's office. In subsequent years, County Auditors calculate how the amounts grow based on each jurisdiction's growth in Assessed Valuation.

Figure 11 shows the combined interaction of these two revenue swaps. While they operate through similar mechanisms, these two "flips" do not affect each other.

Figure 11: The VLF for Property Tax Swap and the Prop 57 "Triple Flip"



V. Frequently Asked Questions About The VLF for Property Tax Swap

1 *The formula allocating each city's share of the $350 million state general fund contribution in FY04-05 and FY 05-06 is based on property tax, sales tax, and VLF. Were each of these sources be reduced?*
No. The city and county contributions were taken from a reduction in "property tax in-lieu of VLF"

2 *How is annual growth in the* ***"property tax in lieu of VLF"*** *determined?*
After the dollar-for dollar swap in FY04-05, county auditors change property tax in lieu of VLF payments (VLF Adjustment Amount) to cities and counties in proportion to each jurisdiction's annual change in gross Assessed Valuation.

3 *Our city has a redevelopment agency and that reduces our property tax revenue growth because property tax growth in the redevelopment project area goes to the agency. Won't redevelopment also affect the growth of* ***"property tax in lieu of VLF?"***
No. The County Auditor calculates your regular property tax allocation, the property tax increment allocation to your redevelopment agency and your AB8 shares first just as would be done absent the VLF for property tax swap. Then the County Auditor looks at the amount you are owed under the swap, which is your FY04-05 VLF loss as calculated and reported by the State Controller with growth in proportion to the growth of gross assessed valuation (i.e. without netting out property tax increment growth going to redevelopment) in your jurisdiction. Thus, redevelopment's property tax revenue is not affected, nor does redevelopment affect your property tax in lieu of VLF payments.

4 *How are annexations affected by the* ***"property tax in lieu of VLF"*** *payments?*
In a change from the Governor's agreement with local governments, the Legislature, in late amendments to AB2115, provided for no property tax in lieu of VLF to replace the lost VLF in annexation areas. The effects of this were largely addressed in AB1602 (Laird 2006) through a reallocation of a portion of the remaining city VLF.

5 *My city was getting a special VLF allocation as a low property tax city. What happened to that?*
County VLF, and special VLF allocation have been converted 100% into property tax in lieu of VLF.

6 *My city has a property tax sharing agreement with the county. Is this* ***"property tax in lieu of VLF"*** *be subject to revenue sharing?*
No. For the purposes of such agreements, the property tax in-lieu of VLF payments should be viewed as VLF revenue. Revenue and Taxation Code Section 97.70(g) provides that tax sharing agreements or revenue sharing agreements are deemed to be modified to account for the reduced VLF. The intention of this law is that these agreements not be affected by the swap of VLF for property tax.

7 *My city has used VLF to back a debt issuance. With the loss of the VLF backfill, what happens to our financing?*
It should not be affected. For the purposes of such agreements, the property tax in-lieu of VLF payments should be viewed as VLF revenue.

8 *Our city is a low property tax city (because a fire district provides us fire service). Does our low property tax share affect what we get from the* ***"property tax in lieu of VLF?"***
It has no effect. The amount you receive in property tax in lieu of VLF depends on how much VLF you lose due to the repeal of the VLF backfill with subsequent annual growth tied to total gross assessed valuation in your jurisdiction. Whether low or high, a city or county's share of secured and unsecured property taxes has no affect.

9 *How does this VLF for property tax swap affect the Proposition 57 triple flip?*
It has no effect. The two operate independently.

10 *How does this VLF for property tax swap affect our existing secured & unsecured property tax revenues?*
The VLF for property tax swap and the "property tax in lieu of VLF" payments have no effect on a city or county's secured and unsecured property tax revenues including Tax Equity Allocations for "no and low property tax" cities.

11 *Is there enough money in the countywide ERAF to cover the payments of both the* ***"property tax in lieu of sales tax"*** *under the Proposition 57 triple flip and the* ***"property tax in lieu of VLF ?"***
With $4.3 billion of property tax swapped for VLF backfill and $1.2 billion in property tax swapped for sales and use tax under the Proposition 57 triple flip, most counties have insufficient money in ERAF to make the in-lieu property tax payments. IN

these cases, the law provides that County Auditors shift the necessary funds from school shares and (as in the case of the ERAF reductions) the school entities are then fully compensated from the state general fund.

12 *Are County Auditors charging cities and counties Property Tax Administration Fees for the* ***"property tax in lieu of VLF"*** *payments?*
Revenue and Taxation Code Section 97.75 prohibits a county from imposing a fee, charge, or other levy in reimbursement for administering the VLF for property tax swap during the FY04-05 and FY05-06 years. Beginning in FY06-07, a county may impose an administration fee or charge, limited to the actual cost of services.

13 *When will cities get repaid for their $700 million contributions over the FY04-05 and FY05-06 Fiscal Years?*
They will not. The local government contributions to the state in FY04-05 and FY05-06 were not loans. The amounts will not be repaid.

14 *If the VLF offset/backfill is 67.5%, why would my city VLF be reduced by over 90%?*
After the repeal of the VLF backfill, funding health and welfare programs provided primarily by counties under a state-local realignment in the early 1990s was maintained. Moreover, the VLF allocation includes certain fixed administrative charges which have not changed, regardless of the amount of VLF revenue. This means that the impact of the loss of the VLF backfill is effectively visited on the remaining allocations, leaving less than $200 million in FY04-05 for per capita allocations to cities in that year. All other allocations (including allocations to counties and special allocations including those to no and low property tax cities) were swapped 100% for property tax. Over 90% of city VLF was be swapped for property tax.

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