ANNEXATION: A TAXING DILEMMA

Does a tax exchange agreement for annexation adopted in 1996 remain relevant for all concerned parties in 2024?

INTRODUCTION/PURPOSE

The San Luis Obispo County Grand Jury investigated Resolution 96-158 which established a Master Tax Exchange Agreement (MTEA), adopted by the San Luis Obispo Board of Supervisors (BOS) on April 24, 1996. The agreement outlines how property taxes will be allocated between the County and a city when a new area is annexed to a city. The agreement, which has not been revised in 28 years, was noted as a contributing factor in some Cities' reluctance to participate in residential annexations.

The Grand Jury sought to determine whether the resolution detailing the tax split between the County and the Cities might be affecting the Cities' willingness to engage in annexation agreements. The consequence of non-participation could impact the availability of new housing projects, including much-needed affordable and low-income options in the region.

ORIGIN

The Grand Jury received comments and concerns from several city officials regarding the current MTEA. This agreement is perceived as unfairly splitting the property tax revenue between the County and the Cities. Despite years of the Cities requesting to re-examine the agreement, it has not occurred.

METHOD/PROCEDURE

The Grand Jury conducted 11 interviews and reviewed the following pertinent documents:

- Resolution 96-158,
- contracts,
- analyses completed by city officials,
- consultancy reports,
- Local Agency Formation Commission (LAFCO) reports, and
- agreements from other counties.

BACKGROUND

Property tax is a major source of revenue for both counties and cities in California. When a county annexes land to a city, it means that the city assumes the responsibility of providing services such as police, fire, water, sewer, parks and recreation, road maintenance, and in some cases libraries in the annexed area. The county maintains its jurisdiction over the area and still must provide some countywide services, such as public health, social services, county road maintenance, sheriff, fire, judicial system, jails, regional planning, and general government functions. Therefore, an equitable property tax split is important to ensure that both the county and the city have adequate funds to provide services.

According to the California Revenue and Taxation Code, the property tax split between a county and a city is determined by a negotiation process that involves LAFCO, the county auditor, and the affected local agencies. The negotiation must address the fiscal impact of the annexation on the county and the city as well as the level and cost of services that each agency will provide to the annexed area. The negotiation must also comply with the state requirements for the county to remain at a minimum revenue neutral, meaning that the county's net revenues after the annexation should not be less than its net revenues before the annexation.

The tax code allows for jurisdictions to adopt a MTEA which may be between the county and the cities or between the county and each individual city. This document serves as a contract and specifies how property tax revenues will be shared when the county annexes land to the city. There is no requirement to have an overarching MTEA, however in its absence there must be a tax exchange agreement created for each individual annexation. The importance of having an overarching MTEA is to provide consistency in the process by making it predictable and preventing protracted negotiations. This is desired by both parties and by potential developers as it enables them to understand the dynamics of proposed projects. It should be noted that these agreements are not fully binding. There are provisions that allow for a mediation process if there is disagreement.

NARRATIVE

On April 24, 1996, the BOS adopted Resolution 96-158 establishing an MTEA. The agreement details how the County and Cities will split property tax revenues when annexations are completed. Despite being adopted as a county-wide agreement, the Cities of Paso Robles, Atascadero, and Pismo Beach did not agree to the MTEA.

The resolution, adopted 28 years ago, was based on a 1996 Fiscal Neutrality Study that was contracted by an external consultancy firm. Several City and County representatives have agreed that circumstances have changed, and the calculations currently used are no longer relevant. Several Cities that would consider annexation in their plans for growth informed the Grand Jury that the MTEA would lead to a financial deficit. As a result, they are hesitant to contemplate new annexations.

There have been annexations since the implementation of the MTEA. The City of San Luis Obispo provided an example of how they overcame the financial inability to provide the initial infrastructure and ongoing services to a new development by imposing a Mello-Roos tax. A Mello-Roos tax is defined as a special tax levied on properties in a Community Facilities District (CFD). This tax is used to finance public improvements and services, including roads, parks, schools, and fire protection. Unlike regular property taxes, a Mello-Roos tax is not based on the property value; rather, it is determined by the benefit received by the property owner from the improvements and services.

In 2019, the San Luis Ranch CFD, was established by the City of San Luis Obispo to fund the necessary infrastructure. In addition to the regular property tax, homeowners in the San Luis Ranch CFD pay an average of $2,750 per year in a Mello-Roos tax. A City representative suggested that if there were a more equitable MTEA the Mello-Roos tax could possibly be reduced or eliminated. Without a Mello-Roos or more tax sharing, the cost of the development infrastructure and ongoing services would be paid by the entire residents of the city.

The Grand Jury discovered that the 1996 resolution requires the County and Cities to re-examine the "policies at five-year intervals to ensure they remain appropriate and current for all parties." However, the Grand Jury found no evidence of completed renegotiations for any of the subsequent five-year intervals. In addition, the Grand Jury reviewed documents dating back to 2018 and received statements that indicate the Cities have requested the County to re-examine the agreement as far back as 2014.

In 2019 the County engaged with all Cities to determine their interest in conducting a new property tax-sharing study. The goal was to provide information for the update of the MTEA to account for the many influencing factors that have changed since the original 1996 agreement. Among the seven Cities within the County, four expressed interest: Arroyo Grande, San Luis Obispo, Paso Robles, and Atascadero. The County and the participating Cities collaborated to develop the scope of a fiscal impact study to help formulate a new agreement.

On November 2, 2021, the BOS approved a contract for $187,400 with a consultant, the Natelson Dale Group, to provide a financial analysis and modeling to inform a revised tax-sharing agreement. Additionally, this contract included an option for each city to contract a unique city-level evaluation. In such cases, the City would be responsible for the cost of their own city-centric study.

The Grand Jury found no evidence that the study was completed per the contract. The original contract, which expired in November 2022, was extended by the County an additional year to be completed by November 2023. The County has advised that the Natelson Dale Group report had not been completed due to the County not providing the data needed for financial modeling. The County Administrators Office advised that they intend to seek approval from the BOS to allow the contract to be extended once again for report completion in 2024. The Grand Jury did ascertain that some Cities engaged and received city-specific information from the contractor. To date the County and Cities have paid approximately $93,000 for the completion of the study. As of the date of this report, several Cities are still actively attempting to engage with the County.

Since policies are not within the jurisdiction of the Grand Jury, the Grand Jury has made no determination as to the equity of the revenue split. The Grand Jury was able to ascertain that given the changed financial circumstances and priorities of the parties, the revenue split is no longer relevant.

CONCLUSIONS

The Grand Jury has concluded that the County of San Luis Obispo has not met the requirement to re-examine the MTEA every five years as required in Resolution 96-158. The County has not taken substantial action despite all parties agreeing that a re-examination is long overdue. The absence of an updated agreement has been noted by some Cities as a deterrent to complete annexations.

FINDINGS

F1. Resolution 96-158, the Master Tax Exchange Agreement was adopted by the San Luis Obispo Board of Supervisors 28 years ago, on April 24, 1996. Although the agreement was not agreed to by all seven Cities within the County, the County has continued to use the agreement as the basis for annexation negotiations.

F2. The County has failed to re-examine the Master Tax Exchange Agreement every five years as required in Resolution 96-158.

F3. In November 2021, the County of San Luis Obispo along with the Cities of Arroyo Grande, Atascadero, Paso Robles, and San Luis Obispo engaged in a contract with an outside consultancy firm to perform a financial analysis to inform a revised tax sharing agreement. The study, contracted for cost of $187,400, has not been completed due to the County not providing the modeling information needed by their consultant.

RECOMMENDATIONS

The Grand Jury respectfully recommends the following:

R1. The Grand Jury recommends that the Board of Supervisors of San Luis Obispo County complete an updated Master Tax Exchange Agreement with the Cities by December 1, 2024.

REQUIRED RESPONSES

The San Luis Obispo County Board of Supervisors is required to respond to R1.

All responses shall be submitted to the Presiding Judge of the San Luis Obispo County Superior Court within 90 days of submission of the report. A paper copy and an electronic version of all responses shall be provided to the Grand Jury.

933.05. Findings and Recommendations

(a) For purposes of subdivision (b) of Section 933, as to each grand jury finding, the responding person or entity shall indicate one of the following:
   (1) The respondent agrees with the finding.
   (2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefore.

(b) For purposes of subdivision (b) of Section 933, as to each grand jury recommendation, the responding person or entity shall report one of the following actions:
   (1) The recommendation has been implemented, with a summary regarding the implemented action.
   (2) The recommendation has not yet been implemented, but will be implemented in the future, with a timeframe for implementation.
   (3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a timeframe for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This timeframe shall not exceed six months from the date of publication of the grand jury report.
   (4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefor.

Presiding Judge	Grand Jury
Presiding Judge Rita Federman Superior Court of California 1035 Palm Street Room 355 San Luis Obispo, CA 93408	San Luis Obispo County Grand Jury P.O. Box 4910 San Luis Obispo, CA 93403

BIBLIOGRAPHY

Chu, Carolyn. “Can Local Governments’ AB 8 Shares Change?” Legislative Analyst’s Office, February 5, 2016. https://lao.ca.gov/LAOEconTax/Article/Detail/169.

Chu, Carolyn. “Why the Mid-1970s Play a Large Role in Property Taxes Today.” Legislative Analyst’s Office, January 27, 2018. https://lao.ca.gov/LAOEconTax/Article/Detail/166.

Church, David. “Special Report – Property Tax Exchange Process and the Master Property Tax Exchange Agreement.” San Luis Obispo – Local Agency Formation Commission (LAFCO), February 15, 2018. https://slocounty.granicus.com/MetaViewer.php?view_id=53&clip_id=2838&meta_id=352709.

City of San Luis Obispo, San Luis Ranch Development. https://www.slocity.org/government/department-directory/community-development/planning-zoning/specific-area-plans/san-luis-ranch.

“Contract for Special Services by Independent Contractor Between County of San Luis Obispo and the Natelson Dale Group, Inc.,” Approved November 2, 2021. San Luis Obispo County Administration Office files.

County of San Luis Obispo Board of Supervisors Meeting Minutes, April 23, 1996: “Approval of Resolution 96-158 Regarding Property Tax Exchange Upon Annexation.”

County of San Luis Obispo Board of Supervisors Consent Agenda, November 2, 2021: “Item 4 approval of a FY21-22 sole-source contract to The Natelson Dale Group, Inc., to provide a financial analysis and modeling to inform a revised tax-sharing agreement.”

County of San Luis Obispo County Tax Collector – San Luis Obispo City – San Luis Ranch CFD – District No 2019-1 Mello-Roos. https://www.slocounty.ca.gov/Departments/Auditor-Controller-Treasurer-Tax-Collector-Public-/Property-Tax-Allocation/Services/Special-Assessments-and-Direct-Charges-(Non-Value-/San-Luis-Obispo-City-San-Luis-Ranch-CFD-(Mello-Roo.aspx.

Crawford, Multari & Starr, Inc. “Annexations and Fiscal Neutrality for SLO County Analysis and Results,” February 1996. Attachment to LAFCO Meeting package, February 15, 2018. https://opengov.slocity.org/WebLink/DocView.aspx?id=89000&dbid=0&repo=CityClerk&searchid=cb56a230-a232-4452-b9aa-956e8297b247.

Economic & Planning Systems, Inc. (EPS). “Tax Report: San Luis Obispo CFD No. 2019-1 (San Luis Ranch)— FY 2021-22.” June 21, 2021. https://pub-slocity.escribemeetings.com/filestream.ashx?DocumentId=662.

"Implementing New Local Jurisdictions or District Taxes." Undated. California Department of Tax and Fee Administration. https://www.cdtfa.ca.gov/industry/local-jurisdictions-and-districts/implementing-new-local-jurisdictions-district-taxes.htm.

Local Agency Formation Commission (LAFCO) meeting package, February 15, 2018: "Special Report – Property Tax Exchange Process and the Master Property Tax Exchange Agreement." https://opengov.slocity.org/WebLink/DocView.aspx?id=89000&dbid=0&repo=CityClerk&searchid=cb56a230-a232-4452-b9aa-956e8297b247.

Multari, Michael. "Open Letter to Mayors of the Cities of San Luis Obispo County." June 10, 1996. Attachment to LAFCO meeting package, February 15, 2018. https://opengov.slocity.org/WebLink/DocView.aspx?id=89000&dbid=0&repo=CityClerk&searchid=cb56a230-a232-4452-b9aa-956e8297b247.

Newman, Matt and Marianne O'Malley. "Policy Brief: Property Taxes: Why Some Local Governments Get More Than Others." Legislative Analyst's Office, August 21, 1996. https://lao.ca.gov/Publications/Detail/214.

"Proposal to Provide Analytical Support for Renegotiation of the County/City Tax-Sharing Agreement." October 2, 2019. San Luis Obispo County Administration Office Files.

"Reconsidering AB 8." Presentation to the California Association of Local Agency Formation Commissions Conference. Legislative Analyst's Office, 2016. https://calafco.org/sites/default/files/resources/2016_Annual_Conference/AB_8_LAO.pdf.

Resolution Accepting a Tax Exchange with the County of San Luis Obispo to Address Tax Transfers from the San Luis Ranch Annexation Area; Annex No. 80. City of San Luis Obispo Council Agenda Report, May 1, 2018. https://opengov.slocity.org/WebLink/DocView.aspx?id=77180&dbid=0&repo=CityClerk&cr=1.