In August 2004, the California Legislature approved a VLF for property tax swap as a part of a state-local budget agreement that also brought Proposition 1A to the ballot. The swap is discussed in “The VLF for Property Tax Swap of 2004: Facts for Local Officials” available on www.californiacityfinance.com. Late changes in the legislation implementing the swap provided inadequate funding for future annexations and incorporations. This report details those provisions and their impacts and explains a recently enacted remedy.

I. VLF and Annexations - Prior Law

Under the law in effect prior to July 1, 2004, the city share of Motor Vehicle License Fee (MVLF) revenues, including any backfill from the state general fund, was allocated in proportion to population.1 As a city’s population grew relative to the statewide population in cities, the city’s share of VLF revenues grew. In addition, as the taxable value of automobiles grew each year, total VLF revenue (including general fund backfill) grew over time, increasing the total pool of revenue to be allocated each year.

These additional revenues to the city essentially came from the growing statewide pot of city MVLF revenue, including the VLF backfill from the state general fund. Because county MVLF allocations came from a county MVLF pot, annexations did not alter MVLF allocations to counties.

II. VLF and New Incorporations – Prior Law

Under the law in effect prior to July 1, 2004, a newly incorporated city received its allocation of VLF revenues based on three times the number of registered voters in the city at the time of incorporation.2 In most cases, new city received VLF on this basis for its first seven years.3 If the city annexed an area, the actual population in that area was added to the three times registered voters figure for the purpose of calculating the city’s MVLF allocation. The three times registered voters basis provided these

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1 For a more thorough discussion of VLF revenues and allocations under prior law, see “The VLF for Property Tax Swap of 2004: Facts for Local Officials” at http://www.californiacityfinance.com/VLFswapNtakeFAQ.pdf.
2 Revenue and Taxation Code Section 11005.3
3 With certain exceptions. See Revenue and Taxation Code Section 11005.3.
cities with a 15% to 150% boost in MVLF revenues depending on the proportion of registered voters in the city.

This boost in revenues to a newly incorporated city essentially came from the growing statewide pot of city MVLF revenue, including the VLF backfill from the state general fund. Because county MVLF allocations came from the county MVLF pot, new incorporations did not alter MVLF allocations to counties, and neither city nor county VLF revenues were the subject of tax sharing.

The three times registered voters allocation basis provided a proxy for population during the first few years of city’s incorporation, when it was difficult for demographics officials to reach a reasonable estimate of actual population. The three-times-registered voters allocation also provided needed additional revenues to a city during its “start-up” years.

III. The VLF For Property Tax Swap of 2004 and Annexations

AB2115, a 2004 budget trailer bill, included the provisions for the VLF for property tax swap of 2004. The changes reduced the VLF rate to 0.65%, repealed the state general fund backfill to cities and counties for reduced VLF rate, altered the allocation of the remaining VLF revenues among cities and counties, and established reimbursement amounts in the form of additional property tax to each city and county for differences as a result of these changes.

The reduced VLF revenue and change in allocations result in cities receiving less than 10% of the VLF revenue they would have received under prior law. However, the difference is made up to cities in additional property tax share.4

Because per capita MVLF allocations to cities under the VLF for property tax swap of 2004 are sharply reduced,5 the amount of additional MVLF coming to a city as a result of new population in an annexation is also sharply reduced. But with regard to annexations, the new law does not make up for the reduced VLF. In late amendments to AB2115, the new law specifies that the Assessed Value of an area during its first year of annexation is to be ignored for purposes of calculating growth in the city’s property tax in-lieu of VLF. The effect of this is to substantially reduce the added revenues that would

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5 Revenue and Taxation Code Section 97.70(c)(1)(C)(ii)(II)
come with an annexation, depending on the extent of build-out of the area upon annexation. The more fully built out the area prior to annexation, the greater the revenue loss to the annexing city.

The effect of this provision is negligible where the area to be annexed is mostly undeveloped. In such a case, the city only loses the effect of the low AV of undeveloped land and growth in assessed valuation after the first year provides increases to the city’s property tax in lieu of VLF sufficient to compensate for the lower VLF revenues.

However, in the case of areas that are already developed with residential uses, the increased land value from the development occurs prior to annexation. This higher AV is to be ignored for the purpose of calculating the city’s property tax in lieu of VLF. In such a case, the city garners less than 10% of the VLF allocation that would have come prior to 2004 from the annexation, but realizes virtually no compensation in property tax in lieu of VLF. The negative impact on the city’s budget from such an annexation compared to the pre 2004 conditions is substantial.

**How Growth in the Property Tax in Lieu of VLF is Calculated**

AB2115 (2004) specifies that the “vehicle license fee adjustment amount” (property tax in lieu of VLF) shall be increased for each city or county by the percentage change from the prior fiscal year for the current fiscal year in gross taxable assessed valuation within the jurisdiction. But it also specifies:

> For the first fiscal year for which a change in a city’s jurisdictional boundaries first applies, the percentage change in gross taxable assessed valuation from the prior fiscal year to the current fiscal year shall be calculated solely on the basis of the city’s previous jurisdictional boundaries, without regard to the change in that city’s jurisdictional boundaries. For each following fiscal year, the percentage change in gross taxable assessed valuation from the prior fiscal year to the current fiscal year shall be calculated on the basis of the city’s current jurisdictional boundaries.\(^6\)

In other words, for purposes of calculating the annual increase in a city’s property-tax-in-lieu-of-VLF, the assessed valuation contained in an area upon annexation is ignored. Future growth in annexation after the first year of annexation is counted for purposes of increasing the city’s VLF reimbursement amount.

\(^6\) Revenue and Taxation Code Section 97.70(c)(1)(C)(i)(II)
Figure E: Example of Additional Taxable AV to a City From an Annexation

<table>
<thead>
<tr>
<th>Year</th>
<th>Original AV</th>
<th>Annexation AV</th>
<th>Total AV</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY04-05</td>
<td>$2,000,000,000</td>
<td>$400,000,000</td>
<td>$2,400,000,000</td>
<td>26.00%</td>
</tr>
<tr>
<td>FY05-06</td>
<td>$2,120,000,000</td>
<td>$424,000,000</td>
<td>$2,544,000,000</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY06-07</td>
<td>$2,247,200,000</td>
<td>$449,440,000</td>
<td>$2,696,640,000</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY07-08</td>
<td>$2,382,032,000</td>
<td>$476,406,400</td>
<td>$2,858,438,400</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY08-09</td>
<td>$2,524,953,920</td>
<td>$504,950,784</td>
<td>$3,029,904,704</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY09-10</td>
<td>$2,676,451,155</td>
<td>$535,290,231</td>
<td>$3,211,741,386</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY10-11</td>
<td>$2,837,038,225</td>
<td>$567,407,645</td>
<td>$3,404,445,870</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY11-12</td>
<td>$3,007,260,518</td>
<td>$601,452,104</td>
<td>$3,608,712,622</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY12-13</td>
<td>$3,187,696,149</td>
<td>$637,539,230</td>
<td>$3,825,235,379</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY13-14</td>
<td>$3,378,957,918</td>
<td>$675,791,584</td>
<td>$4,054,749,502</td>
<td>6.00%</td>
</tr>
<tr>
<td>FY14-15</td>
<td>$3,581,695,393</td>
<td>$714,933,258</td>
<td>$4,306,628,651</td>
<td>6.00%</td>
</tr>
</tbody>
</table>

Figure E shows an example of the effect of an annexation on the taxable AV of a city. Absent the annexed area, the AV of the city is growing at 6% per year. The annexation area which (in this example) is fully built-out, represents a 20% increase in the AV of the city and also increases in value at 6% in subsequent years.

But as Figure F shows, the initial AV in the annexed area is ignored for the purpose of calculating growth in the property tax in-lieu of VLF. In this case, because the annexation area is built-out its AV in subsequent years grows at a similar rate to the original city, and annexation results in no change in the factors used by the county auditor to determine growth in the city’s property tax in lieu of VLF. The annexation does not increase the city’s VLF adjustment amount from property tax, and the city receives less than 10% of the VLF it would have received under the prior law.

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7 In this example, the annexed area is fully built out upon annexation.
Figure F: New Law Ignores Added Annexation AV for Calculating PropTax In Lieu of VLF

For the purpose of calculating growth in prop tax in-lieu of VLF, the County Auditor disregards AV in annexed area in first year.

Figure G below contrasts the additional VLF revenue (including state general fund backfill) to the city from an annexation under the prior law, to the additional VLF (and lack of property tax in-lieu of VLF) under the new law.
The Effect Depends on How Developed the Area is at Annexation

The fiscal impact of this provision of AB2115 relating to annexations varies depending the degree of build-out in an annexation area. In an area that is largely undeveloped, where the growth in taxable assessed valuation in the area will be recognized a year or more after the annexation, the fiscal impact is less. That’s because the growth in AV after the first year of annexation will contribute to growth in the city’s property tax in-lieu of VLF. The city loses growth in property tax in lieu of VLF from the AV that exists at the time of annexation.

Figure H below shows an area that is not fully built-out upon annexation. In this example, the AV of the area upon annexation is about 10% of the original city AV. A year after annexation, the area becomes fully built-out and doubles in AV.

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8 In this example, the annexed area is fully built out upon annexation.
Under the new law, the AV of the area in the first year of annexation is ignored for the purpose of calculating growth in the city’s property tax in-lieu of VLF. But the substantial growth in the area in the following year does factor in to the growth in the city’s property tax in-lieu of VLF.

---

9 In this example, the annexed area is fully built a year after annexation. Annexation increases city taxable AV 10% upon annexation and about 10% in the second year after annexation.
Figure I: Example of Additional Taxable AV to a City From an Annexation

<table>
<thead>
<tr>
<th>Original AV $</th>
<th>Annexation AV $</th>
<th>Total AV $</th>
<th>AV Change</th>
<th>PropTax In-Lieu of VLF Should Be $</th>
<th>AV Change</th>
<th>PropTax In-Lieu of VLF Should Be $</th>
<th>AV Change</th>
<th>PropTax In-Lieu of VLF Should Be $</th>
<th>AV Change</th>
<th>PropTax In-Lieu of VLF Should Be $</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,000,000,000</td>
<td>200,000,000</td>
<td>2,200,000,000</td>
<td>16.00%</td>
<td>2,690,459</td>
<td>6.00%</td>
<td>2,690,459</td>
<td>6.00%</td>
<td>2,690,459</td>
<td>6.00%</td>
<td>2,690,459</td>
</tr>
<tr>
<td>2,120,000,000</td>
<td>424,000,000</td>
<td>2,544,000,000</td>
<td>15.14%</td>
<td>3,120,933</td>
<td>6.00%</td>
<td>3,120,933</td>
<td>6.00%</td>
<td>3,120,933</td>
<td>6.00%</td>
<td>3,120,933</td>
</tr>
<tr>
<td>2,347,200,000</td>
<td>449,440,000</td>
<td>2,796,640,000</td>
<td>6.00%</td>
<td>4,037,519</td>
<td>6.00%</td>
<td>4,037,519</td>
<td>6.00%</td>
<td>4,037,519</td>
<td>6.00%</td>
<td>4,037,519</td>
</tr>
<tr>
<td>2,676,451,555</td>
<td>504,990,784</td>
<td>3,181,441,339</td>
<td>6.00%</td>
<td>4,536,566</td>
<td>6.00%</td>
<td>4,536,566</td>
<td>6.00%</td>
<td>4,536,566</td>
<td>6.00%</td>
<td>4,536,566</td>
</tr>
<tr>
<td>2,837,038,225</td>
<td>535,290,231</td>
<td>3,372,328,456</td>
<td>6.00%</td>
<td>5,067,275</td>
<td>6.00%</td>
<td>5,067,275</td>
<td>6.00%</td>
<td>5,067,275</td>
<td>6.00%</td>
<td>5,067,275</td>
</tr>
<tr>
<td>3,007,260,518</td>
<td>567,407,645</td>
<td>3,574,668,163</td>
<td>6.00%</td>
<td>5,403,111</td>
<td>6.00%</td>
<td>5,403,111</td>
<td>6.00%</td>
<td>5,403,111</td>
<td>6.00%</td>
<td>5,403,111</td>
</tr>
<tr>
<td>3,187,696,149</td>
<td>601,492,104</td>
<td>3,789,148,253</td>
<td>6.00%</td>
<td>5,727,268</td>
<td>6.00%</td>
<td>5,727,268</td>
<td>6.00%</td>
<td>5,727,268</td>
<td>6.00%</td>
<td>5,727,268</td>
</tr>
</tbody>
</table>

Figure J below contrasts the additional VLF revenue (including state general fund backfill) to the city from an annexation under the prior law, to the additional VLF (and lack of property tax in-lieu of VLF) under the new law. Note that the loss to the city pertains to the amount of AV in the annexed area at the time of annexation. In this case, since half the build-out AV exists at annexation, the city loses half the property tax in-lieu of VLF it should receive.

A city garners additional property tax in lieu of VLF only to the extent that development in the annexed area occurs after annexation.

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10 In this example, the annexed area is fully built a year after annexation. Annexation increases city taxable AV 10% upon annexation and about 10% in the year after annexation.
Figure J: Additional VLF (including State General Fund Backfill) from an Annexation

IV. The VLF For Property Tax Swap Of 2004 and Recently Incorporated Cities

Revenue and Taxation code Section 11005(b) as contained in AB2115 of 2004 provides that recently incorporated cities receive their three times registered voters VLF “bump” entirely from the residual MVLF account, before MVLF per capita allocations are made to cities. The new law directs the State Controller's Office to determine, for cities for whom Revenue and Taxation Code Section 11005.3 applied on August 5, 2004, the additional amount of VLF revenue each city would receive as a result of Revenue and Taxation Code Section 11005.3 (that is, with an

11 In this example, the annexed area is fully built a year after annexation, doubling the AV of the annexed area.
allocation based on three-times-registered voters versus an allocation based on estimated actual population).

In addition, these recently incorporated cities receive a per capita allocation from the residual MVLF account along with other cities, based on estimated actual population. Finally, like other cities, they receive a “VLF adjustment amount” (property tax in lieu of VLF) amounting to the difference between their total MVLF revenues in FY04-05 and what they would have received from MVLF in FY04-05 had the prior law remained in effect.

V. The VLF For Property Tax Swap Of 2004 and New Incorporations

Nothing in the 2004 law directly alters past or future property tax sharing agreements or formulas among local governments. Neither county nor city VLF has been the subject of property tax sharing in the past and neither must its successor revenues: the Property Tax in Lieu of VLF (or “VLF adjustment amount”). However, the AB2115(2004) substantially reduced the amount of VLF revenue available to new cities and provides no property tax in lieu of VLF as compensation.
No VLF “Bump” for Future Cities

The 2004 law provides Revenue and Taxation Code Sec 11005.3 funding (the three times registered voters basis) only to cities for whom that section applied on August 5, 2004. Consequently, the 2004 law did not provide this VLF revenue bump to cities that may incorporate in the future.

No Property Tax in Lieu of VLF for Future Cities

Provisions of AB2115(2004) specify that County Auditors calculate and transfer to each city and county an allocation of property tax in lieu of VLF (the “VLF Adjustment Amount”) based on each agency’s FY04-05 revenues. Specifically, the property tax in lieu of VLF is the difference between:

- what the agency would have received in FY04-05 under the prior law, including a 2% VLF rate and prior allocations, and
- what the agency actually receives from the MVLF account given the 0.65% rate and new allocations.

In FY05-06 and subsequent years, each agency’s property tax in lieu of VLF is increased from the prior year amount in proportion to the agency’s increase in gross taxable assessed valuation.

A city that is not in existence in FY04-05 has no VLF adjustment amount (property tax in lieu of VLF) and the new law provides no procedure to establish one.
VI. AB1602 (Laird 2006): Additional VLF Allocations for Annexations and New Incorporations

AB1602 (Laird 2006), passed by the Legislature and signed by Governor Schwarzenegger in 2006 is intended to remedy the lack of Property-Tax-in-Lieu-of-VLF. The bill attempts to remedy the inadequate property tax in lieu of VLF under provisions of AB2115 (2004) by providing a reallocation of a portion of the remaining VLF revenues to cities.

As described in Sections I and II of this document, VLF allocations to new cities and annexations have always come from the shared pot of VLF revenues available to all cities. In effect, a new annexation or incorporation draws down a bit from all cities. No state or county revenues are affected. Policy makers in the Legislature argued that, likewise, a new annexation or incorporation should not cause a reduction in state revenues, i.e. through an increase in property tax in lieu of VLF to the annexing or new city.14

In response, the League of California Cities sponsored AB1602 which provides for reallocations of the remaining VLF revenue that is distributed among cities. These new AB1602 allocations compensate annexing and new cities for a lack of property tax in lieu of VLF. In addition, AB1602 provides a newly designed temporary bump of revenues to incorporating cities for their start-up years.

Inhabited Annexations

For annexations that have pre-existing residential development, AB1602 effectively increases the per capita VLF allocation to levels comparable to pre-2004 allocations. This effectively compensates a city that annexes a developed residential area from the lack of property tax in lieu of VLF due to provisions of AB2115. There are no substantial negative fiscal impacts of AB2115 on the annexation of undeveloped areas.

Figure P

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14 An increase in VLF in Lieu of Property tax revenues to a city effectively reduces the amount of property tax allocated to local schools, which the state general fund has to make up –resulting in no impact to the schools but an added cost to the state general fund.
AB1602 provides a new per capita annual allocation of city VLF revenue to cities\textsuperscript{15} that annex areas after August 5, 2004 for the population residing in those annexed areas at the time of annexation. The per capita amount is $50 adjusted to essentially mirror the annual growth in per capita VLF allocations prior to 2004. The $50 amount is increased for the growth in statewide collection of VLF revenues since 2004 and decreased by the growth in statewide population in cities since 2004.\textsuperscript{16}

Cities get this new per capita allocation for each person residing in an annexed area at the time of annexation in addition to the allocation of VLF revenues that are allocated among all cities. This additional allocation helps to compensate for the lack of VLF in lieu of property tax revenue related to pre-existing development. However, the city will always receive greater tax revenue (including VLF and property tax) if urban development occurs after annexation and not before.

The provisions of AB1602 sunset on June 30, 2009.

**Incorporations after 2004 (But Before July 1, 2009): New Additional VLF**

For incorporations of new cities after 2004, AB1602 provides a new allocation of per capita VLF revenue to compensate for the lack of property tax in lieu of VLF. Together with the per capita VLF allocation provided to all cities in Revenue and Taxation Code Section 11005(e), this effectively provides a level of VLF revenue comparable to the amounts that the city would have received under the law as it existed prior to 2004.

Like the new AB1602 per capita allocation provided to annexations, the additional per capita amount for new incorporations is $50 adjusted to essentially mirror the annual growth in per capita VLF allocations prior to 2004. The $50 amount is increased for the growth in statewide collection of VLF revenues since 2004 and decreased by the growth in statewide population in cities since 2004.\textsuperscript{17}

Cities that incorporate after 2004 but before July 1, 2009 will receive this new per capita annually for the total population in the new city, including population growth.

\textsuperscript{15} These provisions apply only to cities incorporated prior to August 5, 2004.

\textsuperscript{16} Revenue and Taxation Code section 11005(d).

\textsuperscript{17} Revenue and Taxation Code section 11005(e).
Incorporations after 2004 (But Before July 1, 2009): Start-Up Years Bump

AB1602 also establishes a new formula to “bump” VLF revenues to newly incorporated cities. For the purpose of allocating VLF revenues to a city incorporating after 2004, but before July 1, 2009, the city’s population will be determined as

- 150% of actual population in the first year of incorporation,
- 140% in the second year,
- 130% in the third year,
- 120% in the fourth year, and
- 110% in the fifth year.18

This provides a more rational formula for additional start-up support for new cities that is not related to registered voters. The new bump formula also applies to other revenue allocations that provide new city “bumps” including the Highway Users (gasoline excise) Tax. Figure R, below, compares the fiscal effects of AB2115(2004) on new city VLF to the remedy provided in AB1602(2006).

The provisions of AB1602 sunset on June 30, 2009. Under the law, cities that incorporate on or before June 30, 2009 will continue to receive these special allocations, but cities that incorporate after the sunset date will not.

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18 Revenues and Taxation Code Section 11005.3(c)
VII. The VLF-Property Tax Swap Increases the Fiscal Reasons to Develop within Incorporated Cities and Not in Unincorporated Areas.

As explained here in detail, the VLF for property tax swap of 2004 provides cities and counties with added property tax to replace VLF revenue under the pre-2004 law. In doing so, this reform decreases the amount of city and county revenue that is tied to growth in population (and statewide growth in registered automobile values) and increases the amount of local revenue tied to the growth in the assessed valuation of real property.

However, city annexations will not receive property tax in lieu of VLF growth for property value growth resulting from development which has occurred prior to annexation. While AB1602(2006) remedies most of this problem by providing an additional allocation of VLF, fiscal analyses will continue to confirm in virtually every case that a city will be allocated more tax revenue if areas are annexed before they are developed.

This is because, under the new law, growth in assessed valuation after annexation is used to increase a city’s VLF Adjustment Amount (property tax in lieu of VLF), but land value existing at the time of annexation is not. To the extent that a land area realizes its potential growth in property value by developing while in an unincorporated area, this denies potential property tax revenue to a future city.

While it is to the city’s financial benefit to annex before development, this distinction does not impact the finances of the county. The county’s VLF adjustment amount is increased annually in proportion to the countywide growth in the gross assessed valuation of real property, including incorporated and unincorporated areas. The greater growth in a city’s VLF adjustment amount from annexing before development has no effect on the county’s VLF adjustment amount or any other revenue. On the contrary, the larger amount of property tax revenue to the city from developing after annexation puts the city in a better position to share more revenues with the county.

Of course, this also has no effect on the amount of taxes paid by taxpayers. The sequence of annexation versus development alters the allocation of property tax revenues to cities, reducing the amount remaining in the Educational Revenue Augmentation Fund. Minimum school funding is maintained as required under Proposition 98.