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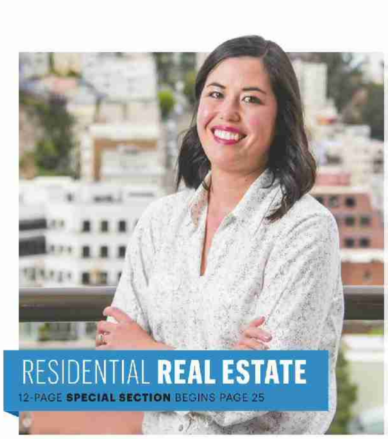
SAN FRANCISCO BUSINESS TIMES

COVER STORY

MANY UNHAPPY RETURNS

To its fans, California's historic 1978 tax-cutting measure retains its youthful vigor four decades on. Are they ignoring signs of an impending mid-life crisis?

BLANCA TORRES, page 4-7



RESIDENTIAL **REAL ESTATE**

12-PAGE **SPECIAL SECTION** BEGINS PAGE 25

The fast and the furious

With demand for homes roaring ahead of supply, hopeful buyers — and their agents, like Miriam Westberg — have to move quicker than ever before. Bringing lots of cash always helps.

BLANCA TORRES, 32

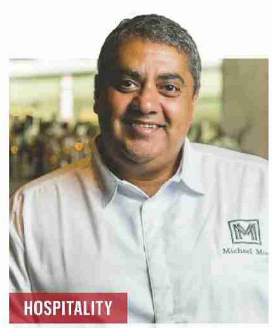
BAY AREA BIOTECH

SPECIAL PULLOUT

Getting a second chance

Cleave Biosciences could have crashed and burned after plowing $100 million into a failed drug. But then it got a lucky break.

RON LEUTY, 12



HOSPITALITY

MICHAEL MINA STIRS THE POT 16

THE LIST RESIDENTIAL REAL ESTATE BROKERS 34

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COVER STORY

7 BIG WAYS PROP. 13 HAS RESHAPED CALIFORNIA

Born as a taxpayer revolt, Prop. 13 continues to ripple through our economy and society

BY BLANCA TORRES | btorres@bizjournals.com

On June 6, 1978, California voters passed Proposition 13. The landmark law slashed property taxes and fundamentally changed how the state and its communities pay their bills.

Over 40 years, its effects have rippled outward to a degree that couldn't have been predicted at the time. California's long-mounting housing shortage, skyrocketing unaffordability and increasing concentration of wealth have occurred under Prop. 13. The tax-reduction measure may not be solely responsible for these changes, but it has surely played a part. It has also had a strong influence on everything from how cities are planned to why it takes longer for today's younger people to buy homes than previous generations.

Prop. 13 passed at a time when home prices and property taxes based on them were both rising quickly, leaving homeowners whose incomes didn't keep up afraid that they would ultimately lose their homes. The goal was "to keep Grandma in her home," by rolling back property taxes and capping future increases at a low rate each year. The cap also extended to commercial properties.

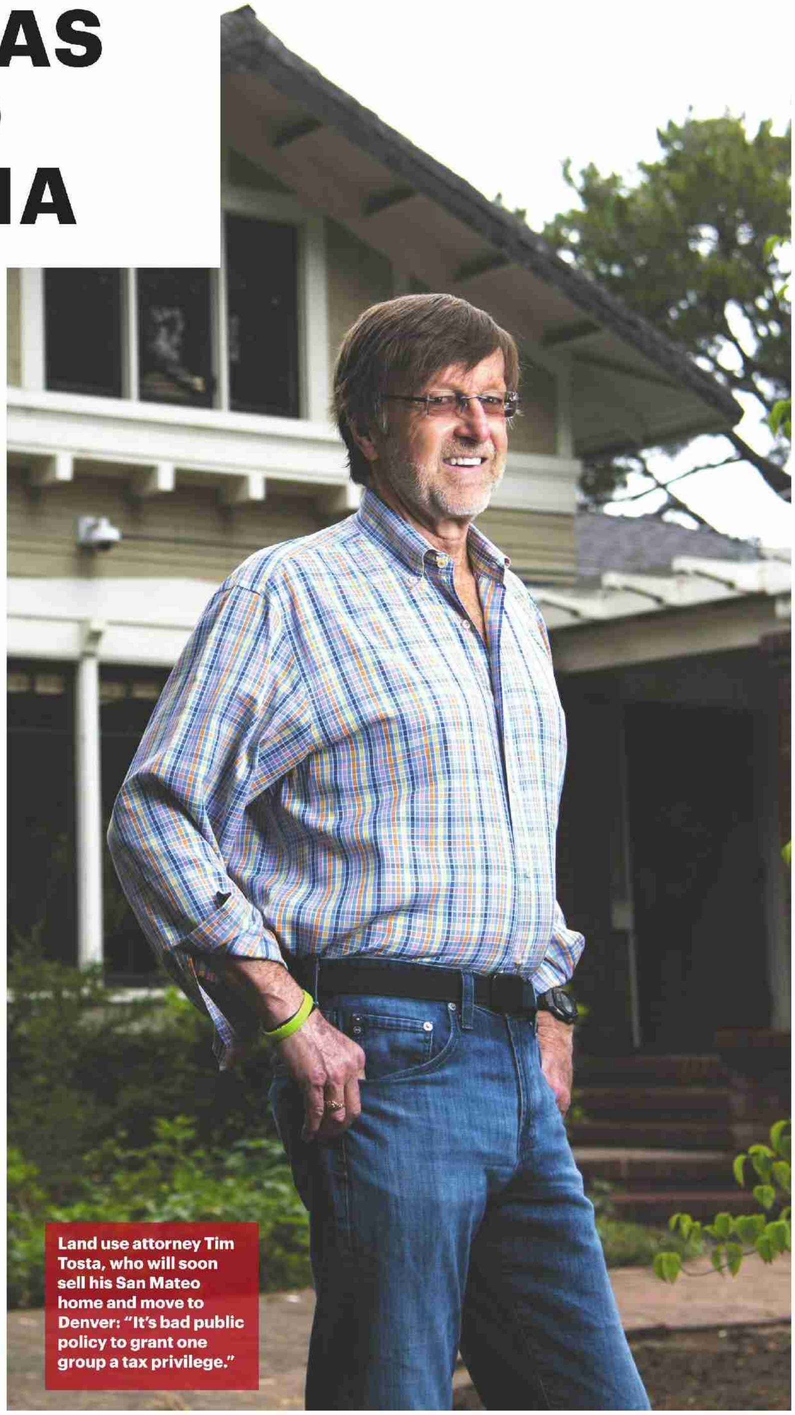
Critics of the policy say while it did make it more affordable for people to stay in their homes longer, it distorts California's high-cost housing market by giving huge tax breaks to older homeowners while saddling younger ones with a much greater share of the bills for the services that all consume.

Now that the law has reached middle age, the Business Times is taking a look at how the tax policy has shaped residents and communities in California – for better or worse.

HOW PROP. 13 WORKS

Prop. 13 sets taxes at 1 percent of a property's assessed value and allows bills to rise by 2 percent per year until the property is sold. (Supplemental taxes for things like school and infrastructure bonds are on top of the 1 percent.) Taxes are reset based on full market value each time the property is sold, so the longer it is held, the greater the tax benefit.

Counties collect the property tax and distribute it to cities and other public agencies on a percentage formula that is largely based on how much those entities received prior to Prop. 13.



Land use attorney Tim Tosta, who will soon sell his San Mateo home and move to Denver: "It's bad public policy to grant one group a tax privilege."

TODD JOHNSON

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EFFECT NO. 1

DOES PROP. 13 KEEP AGING HOMEOWNERS IN THEIR HOMES — OR TRAP THEM?

George Topor moved into his home in the Marin County town of Corte Madera in the mid-1970s. It was an ideal house for raising a young family: three bedrooms and two bathrooms with a yard. The price was $55,000.

Today, its value is about $1.4 million, according to real information company Zillow. Topor's two kids are long grown and gone, so now the 77-year-old and his wife of more than 40 years, Susan, live in the home with no intention of moving. The family spent more than a decade in the Midwest for Topor's job managing restaurant chains for General Mills and Quaker Oats. The Topors rented out the Corte Madera house, knowing they would eventually come back to stay.

"If we moved and we sold the house, where do you go? Because you can't transfer your (limited) property taxes everywhere and, we'd have rather significant capital gains taxes," he said. "If you like your house, you like where you live, and it's not a hardship, why would you move?"

While the Topors' home value has jumped 25-fold, their property tax bills have only inched up. When Prop. 13 went into effect, the Topors' tax bill was immediately cut in half from about $1,300 a year to $650. Forty years later, it's about $2,000, after some exemptions available to seniors.

"The value of the house goes up, but I don't have any of that money in my pocket, so why should my taxes go up?" George Topor asked.

But while Prop. 13 keeps some older Californians in their homes, it traps others in them.

Karen Mendelsohn Gould, an agent with Pacific Union International, meets with dozens of would-be sellers who have paid off their homes and are considering cashing out. After some calculations, even people who could walk away with more than $1 million after capital gains usually decide to stay put, she said.

"If a seller wants to be a buyer, that's a painful conversation," she said. "A lot of them don't end up selling."

The pain comes in when would-be sellers realize that the low tax rate they have been paying for decades could multiply by five or 10 times if they were to purchase a different home. That is unless they fall under another state law, Prop. 60, which allows homeowners age 55 and older to transfer their property tax rates to another home under certain restrictions.

'The value of the house goes up, but I don't have any of that money in my pocket. Why should my taxes go up?'

GEORGE TOPOR, Bay Area homeowner for more than 40 years

Not going anywhere: George and Susan Topor raised their family here, and Prop. 13 gives them an incentive to stay.

TODD JOHNSON

EFFECT NO. 2

LOW INVENTORIES MEAN HIGHER HOME PRICES

If Prop. 13 has had beneficial effects for longtime homeowners, it has had major consequences for people entering the housing market.

"Prop. 13 has reduced the housing stock," said Ed Del Beccaro, managing director of commercial brokerage firm Transwestern and vice chair of the East Bay Economic Development Alliance. "When baby boomers stay in their house, then young people can't move in.

"We have created gentrification-in-place where people will not move out of their house," he said. "They might have needed four bedrooms when they had three kids, but now it's just one or two people in the house."

A functional housing market has a certain level of churn in which owners cycle in and out of homes as their lives progress, said Selma Hepp, chief economist with residential brokerage firm Pacific Union International. Some homeowners stay because they locked in attractive long-term mortgage interest rates or they don't want to pay capital gains taxes if they were to reap big profits from selling their home, but a low property tax base that they would surrender on sale is also a deciding factor.

The fact that people stay in their homes for a long time combined with a lack of new supply result in soaring house prices, Hepp said. Inventory levels fluctuate regularly throughout the year, but they have steadily declined in the Bay Area during the past decade from 46,755 homes on the market in July of 2008 to 12,264 in March of this year — a 74 percent drop. During the same period, however, the price of a single-family home ballooned by 75 percent to a Bay Area median price of $980,000.

Low inventory is a statewide problem. The Legislative Analyst's Office estimates that from 1980 to 2010, the state added about 2.4 million homes, but should have added 4.2 million to keep up with housing needs and to prevent the current housing crisis. The greatest shortfall of new housing is in coastal areas, which needed to add about 100,000 more units per year to keep up with demand, the agency found.

'Even if young people buy a home, they are spending so much more of their incomes on their mortgage than previous generations. What is their opportunity to move up the economic ladder?'

SELMA HEPP, Chief economist, Pacific Union International

EFFECT NO. 3

PROP. 13 LIMITS OPPORTUNITIES FOR YOUNG CALIFORNIANS TO BUILD WEALTH

The people who have the hardest time breaking into the Bay Area housing market are younger or those moving in from outside the area, Hepp said.

"Even if young people buy a home, they are spending so much more of their incomes on their mortgage than previous generations," Hepp said. "What is their opportunity to move up the economic ladder? A home purchase is still the No. 1 way to build wealth."

The number of starter homes on the market has been going down, which limits opportunities for younger buyers in particular. Statewide, since Prop. 13 came into effect, the share of people under 45 years old who own homes tanked. For 25 to 35 year olds, the homeownership rate fell from 40 percent in 1980 to 26 percent in 2014. It dropped from 64 percent to 44 percent among 35-to-45-year-olds.

"Resentment is exactly the right word" for how many young people in the Bay Area, especially renters, feel about Prop. 13, said Laura Foote Clark, executive director of YIMBY Action, a group that advocates for more housing in the Bay Area.

"It is a massive injustice," she said, that some homeowners are allowed to accumulate huge amounts of wealth while the younger generations shoulder the cost.

"You have a group of people who are housing secure who are interested in protecting neighborhood character and protecting their parking spot," she said. "They don't recognize that the economy is fundamentally different than when they were young."

CONTINUED ON PAGE 6

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CONTINUED FROM PAGE 5

EFFECT NO. 4

SAME HOMES, SAME INCOMES — WILDLY DIFFERENT TAXES

At the same time, recent homebuyers end up paying much higher property taxes than their neighbors for a similar-sized home in a similar neighborhood.

In a 2016 report, the state's Legislative Analyst's Office analyzed 45-to-55-year-old homeowners with homes worth $575,000 to $625,000 and incomes of $80,000 to $90,000 in the Bay Area. The agency found that their property tax payments in 2014 ranged from $1,350 to $7,500.

Recent homebuyers take notice of the disparity in tax rates, but tend to not get upset about it, said Dianna Salinas, an East Bay agent with Front Porch Realty Group. They usually just factor in taxes in the overall cost of buying a home and do not place blame on the retiree across the street.

EFFECT NO. 5

CITIES PRIORITIZE COMMERCIAL DEVELOPMENT OVER ADDING HOUSING

Prop. 13's effect on city land use and planning decisions is perhaps its worst outcome, said Denise Pinkston, a partner with San Francisco development firm TMG Partners.

When Prop. 13 came into effect, property tax revenue plummeted by about a third statewide. Since then, cities have had to look for other ways to raise revenue to pay for services that residents demand such as roads, sewers, parks, schools, police and fire departments.

Enter commercial properties such as shopping centers, hotels, office buildings and warehouses. Those uses tend to generate more property tax revenue than housing while requiring fewer services, Del Beccaro said.

The effect has been that city officials zone sections of their cities as commercial even if the most pressing demand and need is for housing.

"Cities are rational actors and they are following the money," Pinkston said. "The money is not in housing."

Before Prop. 13 went into effect, more than 95 percent of city and county revenues came from property taxes. Since it went into effect, the share of revenue from property taxes sunk to about 60 percent with cities and counties relying much more heavily on sales, occupancy and utility taxes.

That trend also exacerbates the high cost of housing in California. Cities pile on fees so that whatever housing is built ends up being more expensive, said David Garcia, policy director for Terner Center for Housing Innovation at the University of California, Berkeley.

In some cases, development or impact fees can add up to $150,000 to the cost of building a new home. Those fees are often earmarked to pay for new parks, traffic intersections and other infrastructure — improvements that in earlier eras might have been funded by property taxes.

"Cities are really limited in their ability to pay for infrastructure, so they pass that on to the cost of housing and that raises the cost to the residents of new housing rather than spreading it evenly across all residents," Garcia said.

TMG Partners' Denise Pinkston: "Cities are rational actors and they are following the money. The money is not in housing."

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Affluent Moraga declared a fiscal emergency, and says Prop. 13 is partly to blame.

SFBT PHOTO 2017

EFFECT NO. 6

IT PUTS A STRAIN ON CITY BUDGETS AND FUNDING

Last year, the East Bay city of Moraga declared a fiscal emergency after a gaping sinkhole near a key intersection put a strain on the city's finances.

The move came as a surprise to many residents because the town of about 17,000 people is one of the more affluent cities in the East Bay with a median home sale price of $1.2 million. Even with high property values, however, the city struggles to raise enough revenue to cover its costs and pay for emergency situations like the sinkhole.

Town Manager Cynthia Battenberg said all California cities have to scrounge up money from other sources to make up for low property tax revenue, but Moraga doesn't have much commercial property and no hotels.

"It's very challenging not to have the sales tax revenue," Battenberg said. "We have millions of dollars of infrastructure needs."

Communities like Moraga share in county property tax revenue, which is largely based on what they got prior to Prop. 13. That amount doesn't fully reflect 40 years of changing demographics.

EFFECT NO. 7

ALL THINGS COME TO THOSE WHO WAIT: THE BIGGER THE HOME, THE BIGGER THE TAX BREAK

Under Prop. 13, the longer a homeowner stays, the greater the reward.

Take, for example, a five-bedroom home on the 4000 block of Happy Valley Road in Lafayette that last sold for $1.317 million in 1994. Zillow estimates that the house is now worth $4.488 million.

If the home sold at that price, the property taxes would nearly double from about $28,000 to roughly $55,000.

That means the current owner of that house gets a tax break of almost $30,000 this year — a break that will grow even larger if the home continues appreciating in value at greater than the 2 percent limit on its property taxes increases.

So, while some owners receive tax breaks worth hundred of thousands of dollars or millions over time, buyers just entering the market are saddled with paying taxes at the current market value.

Land-use attorney Tim Tosta is one of those longtime homeowners. He paid $1 million for his five-bedroom home in San Mateo in 1990 that now has an estimated value of more than $5.8 million. He plans to sell his home in the next few years and move to Denver, where he has already purchased a house. Tosta pays less than $25,000 per year in property taxes and supplementals; the next owner will pay more than $100,000.

"It's bad public policy to grant one group a tax privilege," he said. "It makes us lazy about paying taxes."

Some homeowners have a sense of entitlement, he said, that they should get a tax break and new people should pay for increased costs of shared resources such as roads, parks and schools.

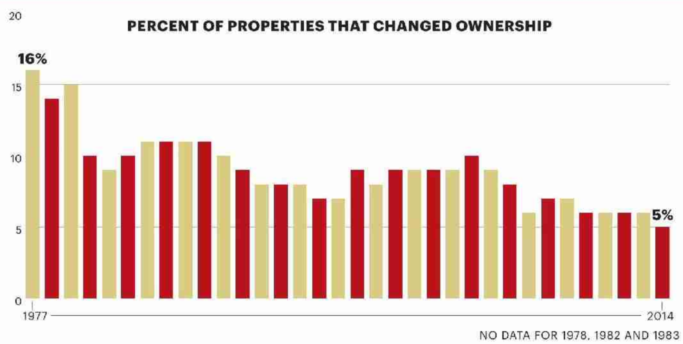
The result, Tosta said, is that "the only people who can move here are the people who can pay for those extras."

And ironically, he said, longtime homeowners are often some of the most vigorous opponents of new housing being developed in their neighborhoods or communities.

PROP. 13 TAKES A TOLL

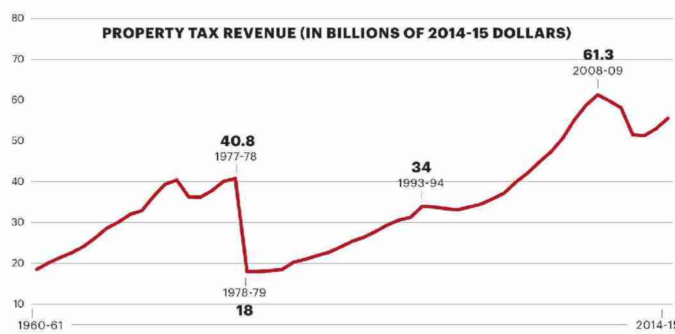
STAYING LONGER, MOVING LESS

The percentage of homes trading hands each year is less than a third what it was before Prop. 13



PEAKS AND VALLEYS

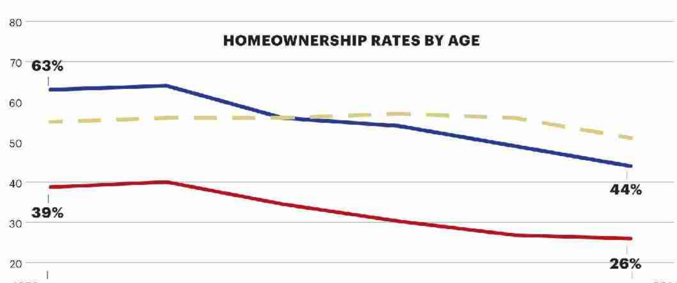
Property tax revenue cratered in the wake of Prop. 13. It took 20 years for it to reach its previous level but soared in 2008-09 on surging home sales — the only time when taxes are reset — but fell sharply again during the Great Recession.



THE GRAYING OF OWNERSHIP

California homeownership rates have changed little over the years, but who owns those homes has: The share of ownership among those 45 and younger has fallen sharply.

35 to 45 year olds
25 to 35 year olds
All



SOURCE: THE CALIFORNIA LEGISLATIVE ANALYST'S OFFICE

WHY IT'S LIKELY PROP. 13 IS HERE TO STAY

Efforts to reform Prop. 13 over the past few decades have failed because there are too many people who benefit from it — especially homeowners. Even some recent buyers, who might pay many times the property tax that their next neighbor pays, want to keep the system in place. Eventually, they could be the ones with the lowest tax base on the block.

"Prop. 13 is such a misunderstood policy and is dangerous from a political standpoint, no one wants to get near it," said Todd Vitzthum, a broker with Greystone Real Estate Advisors Inc.

He likened it to rent control in San Francisco as a "policy that no longer makes sense," but is so entrenched, it won't go away anytime soon.

Younger Californians and renters who are hurt by Prop. 13 are demanding reforms, said Laura Foote Clark, executive director of YIMBY Action.

The latest push to reform Prop. 13 involves what's known as a split roll system where commercial properties would be re-assessed on a periodic basis instead of just when the property is sold. The idea is that landlords and companies with valuable real estate assets such as an office building will pay taxes on those rising values. Proponents of one ballot measure for this fall's election pulled out and are now aiming for 2020, although a group of voters is also collecting signatures for this fall's ballot.