

COMMUNITY FACILITIES DISTRICTS THE MISUNDERSTOOD AND SOMETIMES HIDDEN USE OF MELLO-ROOS TAXES ACROSS SAN DIEGO COUNTY

SUMMARY

The passage of Proposition 13 in 1978 created limitations on communities and developers, making it much more difficult to publicly finance the building of new housing or community improvements in California. The California State Legislature reacted in 1982, passing the Mello-Roos Community Facilities Act, circumventing that legislation by creating new financing options.¹ The co-authors of this bill were Henry Mello, a Senator from Watsonville, and Mike Roos, an Assemblyman from Los Angeles. This act allows local governments to create special taxing districts to collect public funding that was lost due to Proposition 13 limitations on property tax collection. The new funding for local public improvements has helped build public works programs and even public services within neighborhoods. Cities, Counties, Special Districts, and School Districts have used these funding mechanisms to great success since 1982. As of January 2022, within the entire San Diego County region there are 201 Community Facilities Districts (CFDs) and 90 more zones within these districts. For example, one district might incorporate the entire city. Zones are smaller geographical areas within the larger districts. There are 936,884 residential properties taxed in San Diego County for FY 2020/21. Of these residential properties, 102,492 were subject to Mello-Roos tax. There were 61,596 that paid Mello-Roos tax in more than one CFD. There were 2,739 that paid tax in six or more CFDs. The average Mello-Roos tax paid annually by homeowners in San Diego County was \$2,162.03.

Unfortunately, transparency, accountability, and oversight of this process, while available, is not easily accessible or meaningful to the prospective homeowner. While all the agencies studied are meeting the requirements of the law, better procedures to enhance transparency and oversight can still be established to assist the public. The Grand Jury recommends that action be taken to build meaningful transparency and oversight into the CFD process. For example, in the Ladera Ranch neighborhood in Orange County, a lack of oversight resulted in Mello-Roos taxes being collected after the bonds in the district had been paid off. The County of Orange was forced to issue refunds to homeowners who had no idea what was happening.² New proposals to grow the opportunities and reach using the 1982 Mello-Roos law are still being developed. Benefit districts and CFDs based around high-rise buildings are new and creative uses for CFD special tax financing.

¹ California Government Code Title 5, Chapter 2.5, Section 53321,
https://leginfo.ca.gov/faces/codes_displaySection.xhtml?lawCode=GOV§ionNum=53321.

² <https://voiceofoc.org/2021/09/when-will-oc-homeowners-in-ladera-ranch-get-property-tax-refunds/>.

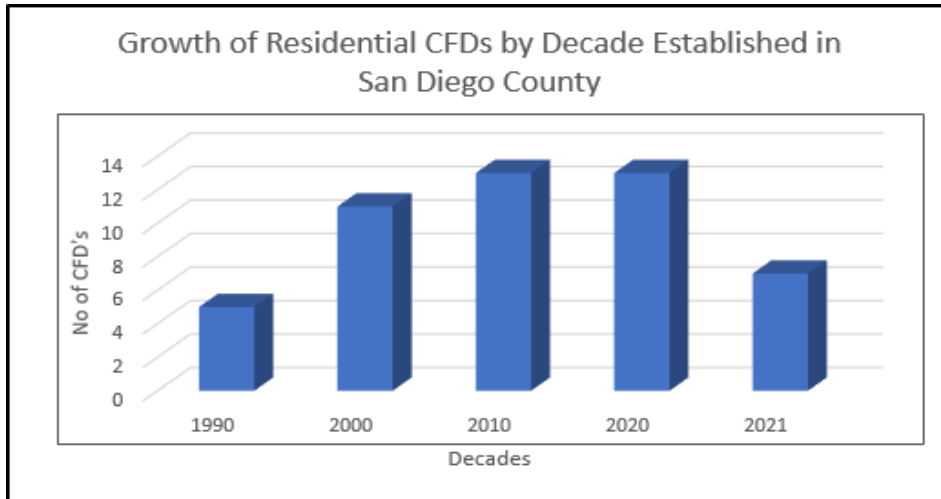


Figure 1: The 2021 total is already nearly half the total from the past decade

INTRODUCTION

Mello-Roos taxes are special taxes issued to homeowners that appear on the County bi-annual tax bill.³ San Diego County organizes their tax bill into two sections. The first section is the traditional tax based on the land and the improvements on the land. Typically, this rate is approximately one percent of the combined value annually. This tax is known as the ad valorem property tax. The property tax is currently tax deductible with a cap if one itemizes deductions on their personal income tax filing. The second section is the Special Tax area. All the fixed charges and voter-approved measures are located here. The Community Facilities District special taxes are also located here. The CFD taxes are created by the Mello-Roos law of 1982. Homeowners will never see the term “Mello-Roos” on their tax bill. These taxes are identified on the tax bill with the initials “CFD” (Community Facilities District). CFD’s are used to fund maintenance and replacement, and in some cases, the construction of public infrastructure projects in new neighborhoods. These projects might include new streets, water and sewer lines, sidewalks, parks, landscaping, lighting, and governmental facilities. In some cases, schools, fire stations, and even water district infrastructure are built using this financing mechanism. The County of San Diego has a tax burden limit where the total of all taxes on property is capped at 1.86%, at the time the CFD is formed, of the estimated sales price of subject properties to an end user within the district. The total tax burden (including Mello-Roos taxes) is the sum of the following:

- Ad valorem property tax levied by the County.
- Voter approved taxes.
- Special taxes for bonded indebtedness. (Mello-Roos taxes)
- Assessments levied for maintenance.

³ San Diego County sample tax bill. <https://www.sdttc.com/content/dam/ttc/docs/new-homeowners-property-tax-guide.pdf>.

- Reasonable annual administrative costs.

An annual escalation of costs may occur with a cap of 2% on the bonded indebtedness and 6% on the maintenance assessment for CFDs if used to fund public services. Any increases cannot exceed the 1.86% cap.⁴ It should be noted this tax burden cap applies at the time the CFD is adopted and is only applicable to the parcels within the region that is under the County of San Diego's land use jurisdiction. Each agency is responsible for setting its own limits. Existing developments are exploring the use of CFD special taxes to fund business improvements, landscaping, and street improvements.

METHODOLOGY

The 2021/2022 San Diego County Grand Jury (Grand Jury) focused on the lack of meaningful transparency and oversight of the CFD process in our research. We interviewed subject matter experts in the operations of the taxation process within the County, the operations of the CFD administrators, financing experts, real estate professionals, and tax-payer advocates. We researched laws of the State of California, best practices from San Diego County and other California counties as shown in Grand Jury reports and numerous news reports from around the State. We interviewed senior staff at the County of San Diego, City of San Diego, and the Cities of San Marcos, Santee, Lemon Grove, Encinitas.

DISCUSSION

Community Facilities Districts can make a home appear more affordable. The non-CFD home will have the costs of any neighborhood infrastructure included in the purchase price. A CFD home will not include those costs in the purchase price. The additional costs will be assessed as a special tax. The developer is relieved from having to add the costs associated with infrastructure onto the price of the property. However, while the home purchase price does cost less, the monthly payment of home price and taxes will not reflect the lower cost. The CFD will add the special tax onto the tax bill and the borrower could end up paying the same or even more total payments than the same non-CFD home without CFD special taxes.

Types of Community Facilities Districts

There are two types of community facilities districts.⁵ The first type is bonded indebtedness, the selling of bonds to finance needed infrastructure in a newly developing community. Roads and sidewalks, parks, water and sewer connections, and school construction are an example of items a CFD might sell bonds to finance. These bonds are paid through a special assessment on

⁴ County of San Diego Board of Supervisors policy for CFDs, https://codelibrary.amlegal.com/codes/san_diego/latest/sandiego_board/i_136___comprehensive__goals_and__policies_for__community__facilities__districts.

⁵ Mello-Roos law, https://leginfo.ca.gov/faces/codes_displaySection.xhtml?lawCode=GOV§ionNum=53321.

each home in the district. Through a Rate and Method Apportionment (RMA) process, the exact amount is figured for each parcel along with a timetable for repayment of the bonds. Rules regarding the operation of the CFD are created at the onset of the district through a resolution or ordinance of the governmental agency that creates the district. Bond terms can vary from twenty to fifty years. The typical CFD term is thirty years. A homeowner who purchases a new home may be on the hook for a payment that lasts for a lifetime.

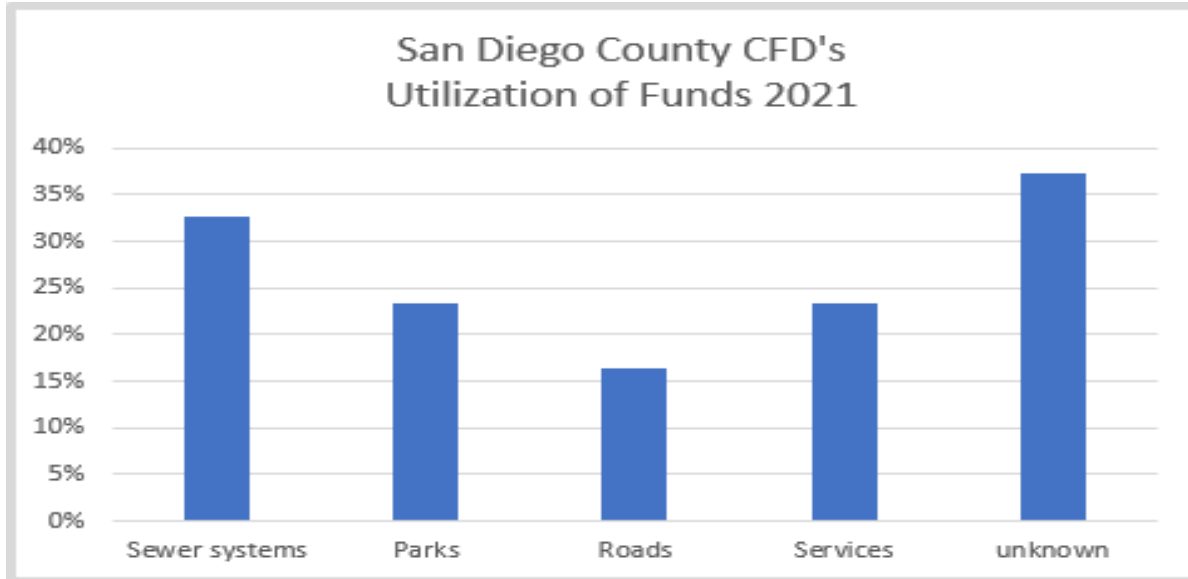


Figure 2: Utilization of Funds.

The second type of CFD is service based. Homeowners within the district pay for ongoing services within their district. Services might include building maintenance, fire protection, ambulance services, park maintenance, police, road maintenance, and school maintenance. The RMA process is used to determine the special tax on each parcel. This tax amount will change as the cost of completing the “service” goes higher over time. Through an annual tax levy assessment, the annual fee is adjusted to pay for the contracted maintenance the district was created to complete.

CFD Best Practices

The typical CFD in San Diego County is created by the local jurisdiction that has land use authority. The first step is for the landowner or developer to work with the governmental agency to determine what exactly will be required for any potential building plan. Examples include roads, parks, schools, etc. If the developer or governmental agency does not wish to pay these costs up front, they may wish to initiate a CFD. The County requires that two thirds of the property owners vote in concurrence when there is a proposed developer-initiated district. Typically, the CFD is created when there is only one property owner, so the two thirds requirement is not a difficult hurdle to accomplish. Foundational documents are created that include the RMA. This is exactly how the special tax will be levied for each parcel. At this point the bond terms for the exact amount and the length of the indebtedness for the district are

determined and any costs for public services and facility maintenance. Each Community Facilities District's foundational documents are unique to that district.

A CFD administrator is selected to determine the tax levy through an RMA process. Often the levy is tied to the square footage of the building on the parcel. Sometime the levy is based on the size of the parcel itself or even based on the number of bedrooms or sleeping areas in a home. With the RMA complete, the governmental agency will hold public hearings to gather input from members of the community. Ultimately, the agency will vote to approve creation of the CFD through a resolution or ordinance of the governmental body. Once the resolution or ordinance to create a CFD is approved the vote of the landowners is held to authorize creation of the CFD. Consultants are now gathered to work on the selling of bonds to fund the transaction. Typically, a team is created including:

- Underwriters
- Bond counsel
- Financial advisers
- Appraisers
- Market study analysts
- Assessment engineers
- Special tax consultants

The role of the CFD administrator with their precise RMA calculations is such a complex process that governmental agencies hire consulting firms to perform this work. The CFD administrator role has become a cottage industry in the State of California. The fees for the administrative costs are set in the foundational documents that create the district. Consulting firms may service multiple districts based on staffing capacity.

Typically, once the tax levy is completed, the bonds can be sold as municipal bonds through financial agencies on the open market and the financing will be secured. At this point, the developer can now begin construction of the necessary infrastructure and the build out of the project. Once homes are completed and sold, homeowners begin paying off the bonds through their annual San Diego County tax bill. Unlike ad valorem taxes, Mello-Roos taxes are not tax deductible because they are considered benefit assessments rather than taxes.

SUMMARY OF THE ACTION STEPS FOR THE ESTABLISHMENT OF COMMUNITY FACILITY DISTRICTS



Figure 3 Summary of steps in the process of building a CFD

Reduction or repeal of CFD levies is possible through Proposition 218, the Right to Vote on Taxes Act.⁶ A Mello-Roos tax on services could be subject to reduction or repeal using local initiative power under this proposition. Using the significantly reduced petition signature requirement, voters within a CFD have a legislative remedy to address issues of inequity with the financing of public services in a community. The standard initiative process for the state of California is to require a percentage, 10 or 15 percent, of all the voters in a city to initiate a voting process for a decision. For Prop 218, only the voters in the CFD need to sign petitions to move a consideration of removing the CFD from the community to a vote. If the community

⁶ Prop 218, https://lao.ca.gov/1996/120196_prop_218/understanding_prop218_1296.html#appendixII.

feels, for example, that a newly created homeowners association can provide services for a lower cost than the CFD, they can request repeal of the special tax through Prop 218 rules.

If voters in a CFD community wish to eliminate or reduce public services, they can use the local initiative process to repeal or eliminate the special tax. Bonded indebtedness is a more legally complex situation to repeal as the bond holders must be paid back prior to closing this type of CFD.

Transparency

An ongoing concern with Mello-Roos financing is the need for adequate disclosure to buyers. Properties within a Community Facilities District might have special tax charges added to the ad valorem tax limited to 1% by Proposition 13. It is essential to emphasize the amount and duration of these special taxes to new buyers so they fully understand they will be paying additional non-deductible CFD taxes to pay off the bonds. California state law requires disclosures be issued to the prospective home buyer regarding Community Facilities Districts. These disclosures are meant to ensure that prospective property purchasers are fully informed about their tax obligations. California Government Code sections 53328.3,⁷ 53328.5,⁸ 53340.2,⁹ and 53341.5¹⁰ require disclosure to purchasers of the existence of a Mello-Roos special tax on a property. The local agency that creates a CFD is required to create, or designate an office to create, an annual report regarding the operations of the district. A notice of special tax must be made available to anyone subject to a special tax levied by the local agency within five days of the request. The local agency may charge a fee for this service not to exceed fifteen dollars. The County of San Diego requires that each purchaser of properties subject to CFDs be given a disclosure prior to sale concerning assessments or special taxes to be levied within the CFD. Copies of these signed disclosures must be provided to the County within 90 days of closing. CFD special taxes can be prepaid if the homebuyer chooses.¹¹

The governmental agency's CFD administrator can provide an up-front payment that will alleviate the buyer from getting a special tax bill.¹² Homeowners need to be educated

⁷ California Government Code Section 53328.3, <https://codes.findlaw.com/ca/government-code/gov-sect-53328-3.html>.

⁸ California Government Code Section 53328.5, <https://law.justia.com/codes/california/2018/code-gov/title-5/division-2/part-1/chapter-2.5/article-2/section-53328.5/>.

⁹ California Government Code Section 53340.2, [https://codes.findlaw.com/ca/government-code/gov-sect-53340-2.html#:~:text=\(a\)%20The%20legislative%20body%20levying,that%20will%20be%20responsible%20for](https://codes.findlaw.com/ca/government-code/gov-sect-53340-2.html#:~:text=(a)%20The%20legislative%20body%20levying,that%20will%20be%20responsible%20for)

¹⁰ California Government Code Section 53341.5, <https://codes.findlaw.com/ca/government-code/gov-sect-53341-5.html#:~:text=The%20tax%20is%20used%20to,WHETHER%20TO%20BUY%20THIS%20PROPERTY>.

¹¹ County of San Diego Board of Supervisors policy for CFDs, https://codelibrary.amlegal.com/codes/san_diego/latest/sandiego_board/i_136___comprehensive__goals_and__policies_for__community__facilities__districts.

¹² California Government Code Section 53321.d, https://leginfo.ca.gov/faces/codes_displaySection.xhtml?lawCode=GOV§ionNum=53321.

concerning these potential special tax surprises. The process is pushed through during the escrow process when a homeowner is presented a thick set of documents to sign or initial. Typically, the time necessary for home buyers to read and consider what all these documents mean or what they will cost is not encouraged.

The local governmental agency that creates a CFD is required to hold public hearings and hold a public vote to create a CFD. The public hearing is held before construction begins and anyone lives in the new development. The property owner is often the only member of the public to attend a public hearing at this point.

Oversight

The responsibility for the oversight function belongs to the local governmental agency that creates the CFD. California Government Code 53340.2 states that the legislative body levying the special tax shall designate an office, department, or bureau to manage the CFD process. The office shall establish procedures to promptly respond to inquiries concerning current and future estimated tax liability. The law also states that neither the designated administrators of the CFD nor the legislative body shall be liable if their estimates are incorrect or if disclosures are not sent to prospective buyers.

Annual reports are created by the designated administrators of the CFDs. The reports are given solely to the legislative body. The public is not given copies of the report or even made aware that the report exists.

FACTS AND FINDINGS

Fact: San Diego County Board of Supervisors policy I-136 regarding Comprehensive goals and policies for Community Facilities Districts describes policy and procedure regarding operations, disclosure, taxing, and management for CFDs.

Fact: California Government Code Section 53328.3 requires the legislative body to record the notice of special tax lien and the Streets and Highway Code Section 3114.5 requires the County recorder index the notice to the names of the property owners.

Fact: California Government Code Section 53340.2 requires the legislative body levying the tax to designate a department to create reports for special tax obligations.

Fact: California Government Code Section 53341.5 requires sellers to notify prospective purchasers of the existence of a special tax through written notice.

Fact: California Government Code Section 53328.3 requires the recordation of any special tax liability with the County recorder's office.

Fact: California Government Code Section 53321 allows local governments to create special tax community facility districts.

Fact: The above code sections list existing statutory requirements and county policy regarding disclosure to homebuyers.

Fact: Special tax disclosure documents may be included anywhere within the package prepared for closing.

Finding 01: Transparency in the CFD process for the homeowner is available but not in a meaningful or helpful way.

Fact: The previously cited Government Code sections include educational information about the CFD process.

Finding 02: Education for the buyer or homeowner does exist but only if they seek out information.

Fact: California Government Code Section 53340.2 requires the legislative body to identify the responsible department, create procedures to respond promptly to inquiries concerning CFD levies on tax bills.

Fact: The intended purpose of a special tax, administrative costs, why a CFD was created, and the duration of the CFD levies are not stated in a consumer-friendly manner

Fact: In all the agencies studied, audits are not regularly performed on CFDs for financial concerns or performance issues.

Finding 03: Oversight of the CFD process is the critical missing ingredient to a comprehensive understanding of individual CFDs. Annual reports that are available are not meaningful to the average homeowner.

RECOMMENDATIONS

The 2021/2022 San Diego County Grand Jury recommends that the County of San Diego's Office of the Assessor/Recorder/County Clerk:

22-23: Take immediate measures to create procedures, over and above what the law requires to ensure that disclosures to homebuyers are included in escrow documents prior to signatures for property purchase. These special tax disclosure documents should be made more visible by possibly moving to the front of the package and requiring a full signature from the buyer prior to turning the signed document back to the County.

The 2021/2022 San Diego County Grand Jury recommends that the County of San Diego, City of San Diego, City Manager for the City of Encinitas, the City Manager for the City of Lemon Grove, the City Manager for the City of San Marcos, and the City Manager for the City of Santee:

22-24: Create procedures for oversight, over and above what the law requires, to include communicating with their constituencies, answering questions, and providing copies of notices or annual reports as requested through direct

action or through their websites. Oversight information should include links to foundational documents, CFD administrator information, current tax levy analysis, and a simple description of the district.

REQUIREMENTS AND INSTRUCTIONS

The California Penal Code §933(c) requires any public agency which the Grand Jury has reviewed, and about which it has issued a final report, to comment to the Presiding Judge of the Superior Court on the findings and recommendations pertaining to matters under the control of the agency. Such comment shall be made *no later than 90 days* after the Grand Jury publishes its report (filed with the Clerk of the Court); except that in the case of a report containing findings and recommendations pertaining to a department or agency headed by an elected County official (e.g. District Attorney, Sheriff, etc.), such comment shall be made *within 60 days* to the Presiding Judge with an information copy sent to the Board of Supervisors.

Furthermore, California Penal Code §933.05(a), (b), (c), details, as follows, the manner in which such comment(s) are to be made:

- (a) 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 therefor.
- (b) 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 time frame for implementation.
 - (3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame 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 time frame 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.
- (c) If a finding or recommendation of the grand jury addresses budgetary or personnel matters of a county agency or department headed by an elected officer, both the agency or department head and the Board of Supervisors shall respond if requested by the grand jury, but the response of the Board of Supervisors shall address only those budgetary or personnel matters over which it has some

decision-making authority. The response of the elected agency or department head shall address all aspects of the findings or recommendations affecting his or her agency or department.

Comments to the Presiding Judge of the Superior Court in compliance with the Penal Code §933.05 are required from the:

Responding Agency	Recommendations	tba
County of San Diego Office of the Assessor/ Recorder/County Clerk	22-23	9/21/22
Chief Administrative Officer County of San Diego	22-24	9/21/22
Mayor, City of San Diego City of San Diego	22-24	9/21/22
City Manager, City of Encinitas	22-24	9/21/22
City Manager, City of Lemon Grove	22-24	9/21/22
City Manager, City of Santee	22-24	9/21/22
City Manager, City of San Marcos	22-24	9/21/22