

Michigan Tax and Finance Policy Affecting Land Use

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May 2003

ISSUE

Michigan influences land use through the tax treatment of land or property, or the investment in land or property, and through statutes that respond to fiscal disparities among school districts and among units of local government.

Tax abatements, credits, exemptions, and finance mechanisms distinguish based on:

- The use of land or property
- The condition of land or property
- The location of land or property
- Whether the investment is a new use or a reuse of land or property

Fiscal disparities are addressed through:

- Funding mechanisms
- Statutes that allow the provision of a specific service or activity on a regional basis
- Mechanisms that permit local units of government to acquire land or to share their tax base voluntarily

Although tax policy affects land use, in many cases it was developed primarily to reduce taxes or encourage economic development.

This paper contains an explanation of current policy, followed by a discussion of policy changes that could affect land use. Because there are 40 statutes that cover the topics of this condensed presentation, it has frequently been necessary to omit some of their details and exceptions.

AGRICULTURAL PROPERTY AND PROPERTY DEDICATED TO OPEN SPACE

Tax Reductions, Credits, and Exemptions

Legislation implementing school finance reform approved by the voters as Proposal A in 1994, provided that homesteads and qualified agricultural property are exempt from local school operating taxes. This exemption makes agricultural property the only business property subject to property taxes that is exempt from the 18 mills levied for local school operating purposes. Agricultural property, like other business property, is subject to the 6-mill state education tax.

Under what is commonly known as PA 116, farmers who agree to retain their land in agriculture for at least a 10-year period qualify for a property tax credit equal to the amount by which their property taxes exceed 3.5 percent of their household income. Farms that do not qualify for an income tax credit may claim a single business tax (SBT) credit equal to the amount by which property taxes exceed 3.5 percent of their adjusted business income. Agreements can be renewed in 7-year increments. Currently, about 45 percent of Michigan farmland is enrolled in PA 116. Credits amounted to about \$30 million in 2001.

When land is taken out of agricultural use, portions of the credits received generally must be repaid or remain a lien on the property.

The same statute authorizes property owners to enter into open space agreements that restrict the use of their property. The value of the development rights is exempt from property taxation. In contrast, farm property is assessed based upon its market value.

The Proposal A Assessment Cap

Under the provisions of Proposal A, the yearly increase in the taxable value of each parcel of property, excluding new construction, is limited to the lesser of 5 percent or the rate of inflation, until ownership of the property is transferred. The legislature has excluded transfers that continue the agricultural use of the property from the definition of transfers of ownership, preventing the assessment from being uncapped when a transfer does occur. A recapture tax requires the owner to repay a portion of the tax benefits resulting from continuing the cap, depending on when the agricultural use ends.

MANUFACTURED HOUSING

Manufactured homes in a licensed mobile home park are exempt from property taxes and subject instead to a \$3 per month fee. The land rented by the homeowner is subject to property tax and is valued based on the rental income paid for park spaces, much as multifamily dwellings are valued based on rent, which includes a tenant's share of the land. Similar homes placed on privately owned land are subject to property taxes.

Manufactured homes are subject to sales or use tax on the full value of the structure. In contrast, stick-built homes are subject to sales and use tax on the cost of the component parts.

Because the addition of a mobile home park significantly increases demand for services and infrastructure such as school buildings, many local officials and residents feel that park owners are not contributing their fair share.

OTHER USE-SPECIFIC TAX TREATMENT

Commercial and Private Forests

Land enrolled in a commercial forest or private forest reserve program is exempt from general property taxes. Instead commercial forests are taxed at \$1.10 per acre. Private forests are taxed at \$1.00 per acre plus a stumpage fee equal to 5 percent of the value of

timber cut. Various penalties for withdrawal apply, depending on how long the property has been retained in the forest reserve program.

Iron Mines

Lands used as iron mines are exempt from property taxes and instead subject to a specific tax based on the capacity and removal of iron from the mine.

Oil and Gas

The value of oil and gas in the ground is not subject to annual property taxes but is instead subject to a severance tax based on the value of production. The tax rate is 6.6 percent for oil and 5 percent for natural gas. In addition, a court decision has determined that this activity is exempt from income tax and SBT.

TAX ABATEMENTS AND EXEMPTIONS

Industrial Property

Local governments can grant property tax abatements for a period of up to 12 years for the creation of new or rehabilitated manufacturing facilities. New facilities receive an exemption of 50 percent of the total tax rate on the property. If the project involves the replacement or restoration of an obsolete plant, 100 percent of the value of the improvements is exempt. It is estimated that owners of property receiving abatements will pay \$340 million less in property taxes in FY 2004. Any city, village, or township may provide these abatements.

Air and Water Pollution Control

Property owners may obtain an exemption for property used for air or water pollution control. The Department of Environmental Quality determines eligibility. There is no restriction as to location. Other than contesting eligibility, local governments have no role in the decision to grant the exemption. It is estimated that the value of this exemption will be \$140 million in FY 2004.

TAX ABATEMENTS LIMITED BY GEOGRAPHIC AREA

Personal Property

“Eligible local assessing districts” can create districts that qualify for a property tax exemption for all new personal property. Eligible projects include most business activities, but exclude retail businesses. Assessing districts are eligible if they meet the definition of distressed area under the State Housing Development Authority Act. The basic criteria are a negative population change, SEV growth since 1972 at a rate less than the statewide rate, a poverty rate greater than the statewide average, and an unemployment rate higher than the statewide average for three of the last five years.

Obsolete Property Rehabilitation Act (OPRA)

Commercial property or commercial housing property that is environmentally contaminated, blighted, or functionally obsolete (it can no longer be used for the function for which it was intended) is eligible for property tax exemptions based on the value of

rehabilitation that may take place. The exemptions must be granted by “qualified local governmental units” and are for a period of up to 12 years. Qualified local governmental units are defined by a complicated set of criteria that include cities and townships with median family incomes less than 150 percent of the statewide average that satisfy one of several population criteria including, for example:

- Adjacency to a city with a population of over 500,000
- A population of 10,000 or more if located outside an urbanized area
- A population of 100,000 or more within a county of 2,000,000 or more

Non-school taxes are imposed on the pre-rehabilitation value of the property. The state treasurer may grant up to 25 exemptions for up to 50 percent of the 6-mill state education tax and 18 local school operating mills for six years. Through December 2002, there were 17 certificates granted locally and all had been given the full 50 percent exemption.

Neighborhood Enterprise Zones

Residential property investment in neighborhood enterprise zones qualifies for property tax reductions for new and rehabilitated facilities. The rate reduction for the owner of a new facility is the difference between the total tax rate in all taxing jurisdictions and half the statewide average tax rate. Rehabilitated facilities have their taxable value frozen. Only “qualified local governmental units,” as defined in the OPRA can form neighborhood enterprise zones. Currently, only eight communities have opted to form these zones.

TAX INCREMENT FINANCING

Before Proposal A

Tax increment financing uses, or “captures,” property taxes from the increase in property tax values (the increment), from a certain starting date, to “finance” designated activities. Often, the revenues are pledged for the payment of bonds issued for capital expenditures.

Prior to the adoption of Proposal A, there were three statutes that permitted tax increment financing. The first, the Tax Increment Financing Authority (TIFA) Act, was a generic statute that permitted cities to capture taxes from all taxing jurisdictions for virtually any purpose. The second, the Downtown Development Authority Act, limited the capture of taxes to downtown areas. In 1986, in response to criticisms and pending legal challenges, the legislature passed the Local Development Financing Act (LDFA), which curtailed substantially the scope of tax increment financing. Only cities and certain “urban townships” could use this statute. Taxes could be captured only from manufacturing, agricultural processing, or high technology property and used only for public facilities that supported the property. At the same time the TIFA act was amended to prohibit the establishment of new authorities under that act.

As part of the implementing legislation for Proposal A, the capture of school taxes under any of the three statutes was eliminated for new projects.

Brownfield Redevelopment

The Brownfield Redevelopment Financing Act, as enacted in 1996, permitted the use of tax increment financing to prevent the spread of contamination from and remediate contamination on specific sites. The act permitted the capture of school taxes for the first time since the adoption of Proposal A. The act was limited to specific eligible property and to a narrowly defined list of eligible activities related to environmental cleanup. There are no location restrictions on the use of brownfield financing for environmental cleanup.

Brownfield Redevelopment Financing in Qualified Local Governmental Units

The 2000 amendments expanded the definition of eligible property to include blighted property, including tax reverted property, and property that is functionally obsolete. This additional eligible property must be in a “qualified local governmental unit.” Eligible activities include site preparation, lead abatement, demolition, infrastructure improvements, and relocation of public buildings. A “qualified local governmental unit” is defined by adopting the definition in the OPRA.

Smart Zones

Amendments to the LDFA act adopted in 2000 expand the definition of eligible property to include business incubators and property used for certain high technology activities. The use of tax increment revenues for these types of property has been expanded to include land acquisition, demolition, site preparation, and relocation costs. With the approval of the state treasurer, 50 percent of school taxes may be captured for smart zones for a period of up to 15 years.

Smart zones are established only through an agreement with the local unit of government and the Michigan Economic Development Corporation.

SINGLE BUSINESS TAX AND INCOME TAX CREDITS SPECIFIC TO PROPERTY TYPE AND LOCATION

Brownfield Investment

SBT credits are available for investment on sites that are part of a brownfield financing plan. A credit equal to 10 percent of eligible investment is available if the total credit will be less than \$1 million. These credits are approved by the Department of Treasury and subject to an annual cap of \$30 million. If the total amount of the credit is between \$1 million and \$30 million, the credit is for up to 10 percent of eligible investment and must be approved by the Michigan Economic Growth Authority.

Tracking the brownfield financing legislation, credits are allowed for investment on contaminated sites in any community, and similar credits are allowed for investment related to blighted, tax reverted, or functionally obsolete property located in a “qualified local governmental unit,” as defined in the OPRA.

Historic Preservation

Michigan provides a credit equal to 25 percent of historic rehabilitation expenditures that qualify for federal tax credits. However, the credit is reduced by the amount of the federal credit, which is 20 percent, so in most cases the credit amounts to 5 percent. In some cases, this credit can be combined with the brownfield credit to produce a total credit of 15 percent of the expenditures for historic rehabilitation.

RENAISSANCE ZONES

Renaissance zones are areas of the state where activity within the zone is virtually tax-free. Residents of the zone are exempt from state income taxes and applicable city income and utility users tax. Business activity within the zone is exempt from single business tax. Property within the zone is exempt from property taxes or alternative specific taxes levied against the property, except for taxes levied for debt service and school sinking fund millages.

There are several different types of zones. Initially, the statute provided for “urban” and “rural” zones. Subsequent amendments created agricultural processing zones, alternative energy zones, and pharmaceutical zones. In most cases zones are initiated locally and must have state approval. In some cases, the process may be initiated by the state with local approval.

FACTORS IMPACTING FISCAL DISTRESS

Fiscal Disparities and Communities Identified as Distressed

One study has analyzed the relationship between fiscal disparities and Michigan communities that have been on the Department of Treasury’s list of fiscally distressed communities. The study concluded that its proposed 10-point scale, when judged by looking retrospectively at those communities, appeared to be a reasonable predictor of fiscal distress. The factors related to producing fiscal disparities included:

- Population growth
- Real taxable value growth
- Large real taxable value decrease, a related but different measure designed to account for the impact of the loss of a large taxpayer
- General fund expenditures as a percent of taxable value
- General long-term debt as a percentage of taxable value

Constitutional Constraints on the Ability to Raise Revenue

The constitutional limitations of the Headlee amendment, approved by the voters in 1978, and the Proposal A assessment cap have restricted the ability of local governments to raise revenue.

Under the Headlee amendment, a local government’s maximum authorized millage rate for each year must be reduced by the percentage by which the increase in the value of existing property exceeds the rate of inflation. The newly calculated rate can be exceeded

only with voter approval. At the same time, the assessment cap restricts the annual increase in the assessment of each parcel of property.

The impact has been particularly significant in cities. The assessment cap has had the effect of reducing rollbacks over the past few years, but has also reduced the revenue yield from each mill of property tax. These reductions have reduced the *effective* millage rate for cities by 15 percent since 1994, even though nominal millage rates increased slightly. Now, as transfers of ownership begin to trigger greater assessment increases, Headlee rollbacks are beginning to reoccur, because the newly added value is included in the rollback calculation.

The interaction of these two restrictions means that new construction is increasingly important to provide increases in property tax revenue. In places where there is no room to grow, these pressures often mean that cities have no additional capacity to levy operating millage without voter approval. In 2001, about half of Michigan cities had effectively no operating millage capacity. In general, there is a strong correlation between communities with relatively low fund balances and those with no millage capacity.

Because of both these constraints and a relatively low per capita tax base, some cities also rely on a city income tax or have shifted a portion of their property tax to an income tax.

STATE PROGRAMS THAT RESPOND TO FISCAL DISPARITIES

School Funding

Under Proposal A, the state collects a 6-mill state education tax on all property, which partially replaces local school operating taxes that were levied prior to its adoption. The revenue is pooled with other school aid fund revenues to fund the per pupil guarantees and other programs funded by the school aid fund.

The per pupil foundation allowance is provided to school districts independent of their local tax base. The state per pupil payment is equal to the difference between what the district raises per pupil locally, from 18 mills levied on nonhomestead property, and that district's foundation allowance.

Although local school district millages are limited, local districts may share up to three mills approved by the voters of their intermediate school district.

Finally, the state makes loans to districts that issue qualified bonds if the debt service on those bonds would require them, based on their tax base, to levy taxes for debt service in excess of certain rates.

Revenue Sharing

Currently, state revenue sharing is distributed from two sales tax pools: one dedicated under the constitution and the other dedicated by statute.

The constitutional share is distributed on a per capita basis. The statutory share is distributed under a formula that has several parts. A portion of statutory revenues is based on how the local unit's taxable value per capita compares to the state average taxable value per capita, with a unit's share increasing, the lower its taxable value per capita.

Another feature guarantees the yield of the first 20 mills of property taxes at a per capita per mill amount determined by the dollars available to fund that portion of the formula.

The extent to which these features of the revenue sharing formula reduce fiscal disparities depends on the funding levels for statutory revenue sharing.

Annexation

Annexation is the process by which land is brought from an unincorporated area, a township, to an incorporated area, a city or village. Typically, developers seek annexation because a city or village can provide services, most likely water and sewer services that the township cannot. Cities or villages are interested in annexing property because the revenue from the resulting tax base is more than the cost of providing these services.

Annexations are frequently contentious because they may be attempted to avoid local zoning determinations, residents do not want to be annexed, or township officials do not want land taken from their jurisdiction.

Land Transfer and Other Intergovernmental Agreements

The “conditional land transfer act” permits two or more local units to conditionally transfer land for a period of up to 50 years. The transfer must be entered into “for the purpose of an economic development project.” The agreement can set forth which of the powers of the transferor local unit are transferred to the transferee local unit. Property does not have to be contiguous for a transfer to occur.

The agreement can include provisions for sharing taxes generated in the transferred area.

Typically, tax rates are higher in the host community, and the township enters into the agreement for some increased share of the millage in the transferred area.

These agreements are generally viewed as the peaceful alternative to annexation, although some land transfer agreements have been overturned by local referendum. Occasionally, cities have entered into land transfer agreements to protect the subject land from annexation by another city.

Land transfer agreements may be a valuable tool when an existing manufacturer wants to expand its facility because they permit a facility to remain within city boundaries but use additional space available within a neighboring township. However, because the land being transferred is not required to be contiguous to the community to which it is transferred, it is possible to create an island of development several miles from city boundaries.

The urban cooperation act also contains provisions for sharing tax revenues from particular areas.

Special Purpose Authorities

A number of statutes permit the delivery of a specific service and the levy of property taxes to fund that service in areas that may include multiple municipalities. Examples include intermediate school districts, community colleges, district libraries, park authorities, and public transit authorities.

In most cases, the statutes are motivated by the practicality and efficiency of performing the activity over a larger area, rather than within a single municipality or school district. The tax base sharing that occurs is more likely a consequence rather than an objective of the statute.

POLICY CHANGES THAT COULD AFFECT LAND USE

Use Value Assessment for Agricultural Property

The Michigan Constitution requires uniformity of assessment. Case law interpretation of this concept has held that all property must be assessed on the basis of its highest and best use. In the case of farmland, this concept means that farmland worth \$1,500 per acre for use as a farm, but \$30,000 per acre for use as a shopping center, must be assessed at the higher value.

Use value assessment would permit the property to be assessed at its value for agricultural use. Creating a use value system can be accomplished by amending the constitution. Another alternative involves exempting farm property from property taxes and subjecting it to an alternative “specific tax.”

Some analysts who have examined use value assessment in other states have concluded that it has not prevented the loss of farmland when compared to Michigan’s farmland loss. Nevertheless, they believe use value assessment results in fairer taxation of farmland.

The interaction of the Proposal A assessment cap and the constitutionally mandated use value assessment, without proper safeguards, can lead to a tax shelter for developers. If land is retained in agricultural use past the next December 31 (the tax status day), its assessment will be capped and never reach its value, even when it is used for other purposes. There will be an incentive to consume, rather than retain, farmland.

Tax Base Sharing

By imposing the 6-mill state education tax and distributing the proceeds through the school aid formula, Michigan is already engaged in tax base sharing for K–12 schools. It is further away for local units of government.

In states where tax base sharing is required, local governments contribute a portion of property tax growth to a regional pool, which is redistributed to local units within the pool area.

Mechanisms of this type are certainly controversial. Although the prospects for a successful legal challenge are limited, claims concerning the diversion of voted taxes to a different purpose and of an illegal lending of credit are likely to occur.

In 1991, Michigan adopted a law that required wealthy school districts to contribute 50 percent of their growth in commercial and industrial property taxes to share with other local school districts. The statute was challenged separately in three circuit courts and, before the litigation was resolved, was repealed in 1993 as part of the implementing legislation for Proposal A.

Impact Fees

Impact fees are one-time levies that are imposed on property developers to offset the provision of additional infrastructure such as roads, parks, or schools and for public safety services that are required by the additional population. Minnesota, Florida, California, and Colorado have taken the lead in their adoption. While some have argued that Michigan local governments can impose impact fees through their ability to set utility rates, the scope of these fees, if they were permitted under Michigan law, would be much more limited.

Some studies suggest that impact fees increase the price of new housing and reduce the price of vacant land. They also have the effect of reducing millage rates, a reduction that increases the price of existing housing.

Split Rate or "Land Value" Taxation

This is a property tax system that taxes land at a higher rate than improvements on the land. Its theory is that lowering the tax rate on improvements will create incentives to build on the land, particularly in urban areas. It has some reported success in parts of western Pennsylvania and has been recommended for the city of Philadelphia.

It can be argued that tax abatements in Michigan produce a form of de facto land value taxation for the property for which they are granted. Michigan's constitutional provision mandating uniform tax rates for all classes of property would require land value taxation to be implemented through an alternative specific tax or a constitutional amendment.

Tax Credits for Land Donation

A number of states provide income tax credits for the donation of land or development rights in land. The credits have had a positive effect in increasing the amount of land preservation in some states.

Credits of this type are an alternative to a direct appropriation for the purchase of land or development rights. Open-ended credits provide less opportunity for controlling overall cost and for developing targeting strategies for land preservation.

Land Banks/Fast Track Authorities and Tax Reverted Property

In 1999, Michigan substantially revised its process for foreclosing on real property on which taxes were unpaid. Prior law provided a lengthy six-year period for obtaining title to the property. In addition, it did not adequately provide for the identification of parties with an interest in the property entitled to notice of a foreclosure proceeding, or for ascertaining addresses for providing notice. Moreover, the state did not adequately fund the process, so that searches did not comply with even these inadequate requirements.

The 1999 amendments shortened the process, and provided for the acquisition of property about two years after the property is returned delinquent on the March 1 following the year of levy. In addition, the new law more clearly defines parties with an interest in the property who must be notified of the proceeding; the procedure for determining those parties; and the procedure for determining the address of those parties. Finally, the statute imposed fees on delinquent taxpayers sufficient to find the cost of the new law.

Frequently, parcels recovered by the state were conveyed to local units of government. Because of the defects of the prior procedure, however, neither local units nor potential purchasers could obtain title insurance on the property. As a result, several units of local government are confronted with substantial numbers of properties for which title clearance must be accomplished.

Transferring property to a land bank or “fast track authority” consolidates these parcels and can provide a single stop for title clearance, marketing and reuse of the property. These authorities will function most effectively if provided seed money and a funding source for their ongoing activity.

The program has reportedly worked well in Atlanta and Fulton County, Georgia.

Drain Code Reform

Reforming Michigan’s half-century old drain code has been attempted by several past sessions of the legislature and is a subject of the current session.

This daunting task is made more difficult by constitutional issues concerning local taxes. The Headlee amendment prohibits any new local taxes, or an increase in the rate of an existing tax, without voter approval. The Michigan Supreme Court has held that the voter approval requirement does not apply to taxes authorized by law prior to the time the Headlee amendment was adopted. Drain taxes authorized under the current drain code are part of this exclusion and do not require voter approval.

Proposals to modify the drain code expand the scope of activities permitted under the drain code, in some cases including new chapters concerning watershed management. Frequently, they have stricken all reference to taxes and describe charges to finance this activity as “assessments.”

There are three choices for classifying amounts paid under a revised drain code: special assessments, fees, or taxes. What matters is not what they are *called*, but what they *are* under Michigan law. They do not meet the test for a special assessment, because they are not related to the benefit to specific property. They do not satisfy the test for fees, because they are not voluntary, providing a property owner neither the option to pay the fee nor to limit the amount of use. Also, they are not likely to be proportional to use. Therefore, they are taxes.

To the extent that drain code changes remove preexisting authority to tax, change the purpose for which the taxes can be used, or can be viewed as increasing the rate of tax, then amounts required to be paid under the drain code would be subject to voter approval.

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