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TO: Detroit City Council

FROM: David Whitaker, Director 
Legislative Policy Division Staff

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RE: Split-Rate Property Taxation in Detroit

The Legislative Policy Division (LPD), the Office of the Chief Financial Officer (OCFO) and the Office of the Assessor have been requested to provide a report regarding the application of a split-rate tax in the City of Detroit. In response to this request, each office has contributed to the preparation of this report.

SUMMARY

Questions have arisen regarding the fairness of the tax rates and whether the level of tax rates levied by various taxing jurisdictions on residential property in Detroit are seriously impeding development and contributing to increased foreclosures. Elected officials and community organizations have taken issue with the high property taxes. The development community has actively sought to engage on how to reform property taxes to stimulate demand. Without fully assessing the underlying statements related to the existence of the problem or any relationship to the consequences ascribed to it, the issue raised is the efficacy and viability of a split-tax rate system in addressing these objectives proposed without negatively impacting the property tax revenues received by the City and other taxing jurisdictions.

Theoretically, the idea of implementing a split-rate tax system in Michigan as presented below may have a positive impact on lowering residential property taxes and/or incentivizing commercial development. However, before investing the considerable amount of time and political capital to bring about the host of essential legislative changes required for this property tax regime, much more research and evaluation appear to be necessary. There are questions that would have to be thoroughly vetted and a determination as to what impact a switch to a split-rate

tax system would have on all the other taxing jurisdictions included on the City's tax bill. These questions include but are not limited to the following¹:

1. The underlying legal structure of the legislation: Constitutional issues regarding uniformity; applicability of Proposal A and Headlee
2. Design questions: Local options for voter approval; taxing jurisdictions inclusion options; Millage exclusions (split millage rates) vs value exemption (split values); type of property included.
3. Ancillary Taxes: What is and should be the impact on replacement taxes under tax abatements statutes and Neighborhood Enterprise Zones (NEZ)?
4. Incentives: Are adjustments needed; Impact on tax capture plans?
5. Exemptions: How are the current exemptions to be treated?
6. Administration: What would be the underlying assessment and equalization process?
7. Unlimited Tax General Obligations (UTGO) and Debt limits: what impact would the new system have?

Again, in theory the split-rate tax system would reduce residential property taxes primarily by lowering the calculus of taxes placed on structures and improvements in general. However, whether it benefits the City of Detroit or other taxing jurisdictions is dependent upon the system being revenue neutral. The split-rate tax must generate revenue equal to or greater than the current system. A failure to achieve this neutrality would be detrimental to services provided by the City and/or other taxing jurisdictions and may have a negative impact on existing debt obligations. The remainder of this report looks at the potential a split-rate tax may provide but we must acknowledge the many outstanding questions that must be answered first.

SPLIT-RATE PROPERTY TAX

A split-rate property tax has been identified as one solution to reducing residential property taxes. The split-rate property tax system is a re-distribution of the property tax assessment, by dividing the basis for the assessment between the value of the land and the improvements. This "split-rate property tax" applies a higher rate of tax to vacant land and a lower rate of tax to the structure and its improvements. The concept could be implemented either through differing millage rates on land versus improvements or through differing equalized value caps on land versus improvements. Each would have the same impact of creating a system of taxation that has different rates of taxation for land and improvement (which is referred to generically herein as a "split-rate property tax"), though each alternative approach may raise different constitutional issues.

This is not a new concept. In 1989, the Detroit City Council received the "Detroit Land Value Taxation Study". The recommendation was to adopt a "land valuation taxation" (LVT) that would reduce the property tax on buildings and improvements and increase the tax on the value of the land. At the time of this study, 84% of Detroit's property tax revenue was derived from buildings and 16% was derived from land. The findings indicated that the average residential homeowner could experience a 42% reduction. This represented a projected average reduction in homeowner property taxes from \$787 to \$454. The other benefits would be neighborhood revitalization and encouraging the development of new business and construction. There would be disadvantages to owners of vacant, unproductive land or commercial/industrial sites with extensive lot sizes, especially for parking lots and storage. At the time of this study, in order to

¹ See attached spreadsheet.

effectuate a lower tax rate on building assessment, it would require the adoption of legislation by the state legislature (Fox, 1989).

More recently, the Lincoln Institute of Land Policy (Cambridge, MA) conducted a 2020 research study for the City of Detroit Office of the Chief Financial Officer (OCFO). According to this study, the City of Detroit property taxes, despite being assessed at a rate that exceeds almost all other U.S. Cities, the property tax revenues that are generated rank fourth, behind city income tax revenue, state revenue sharing, and wagering tax revenue. The study noted that these higher tax rates on residential property coincide with “higher rates of tax delinquency, home abandonment, and foreclosures” (Lincoln Institute, p.4). One of the stated advantages of the split-rate property tax is it also acts as a disincentive to allowing land to remain vacant and serves as an incentive for (re)development (Lincoln Institute, p.4).

The Lincoln Institute study looked at municipalities in Pennsylvania, which instituted the split-rate tax in 1979-80, and findings indicated several possible benefits to implementing in the City of Detroit, in the areas of tax delinquency, business formation, and effects on property value:

Tax Delinquency, Foreclosure and Homeownership

- The split-rate tax reduces residential property taxes, resulting in a reduction in tax delinquencies and foreclosures.
- The study forecasted that a 5-to1 split-rate tax in Detroit would reduce the foreclosure rate by -8.6%.
- Home ownership increases.
- The projection for Detroit is that the implementation of the split-rate tax would result in more residential properties complying with their property tax assessments and thereby reduces the number of homeowners subject to tax delinquency and foreclosure.

Business Formation

- The study of Pennsylvania municipalities found that the implementation of the split-rate tax saw an immediate increase in the number of wholesale, retail, construction, manufacturing, and transportation related business (p.5).
- After the initial increase in the number of businesses, there was an approximate 5% decline in the number of new businesses.

Property Values

- Split-rate taxation was found to have a significant and positive impact on both residential and commercial property values (p.6).
- The impact on land values was found to be modestly negative, declining 2% with a 2-to-1 tax ratio and 8% with a 5-to-1 tax ratio.

PROPERTY TAX ASSESSMENTS

In the State of Michigan, property tax bills are issued by the city or township treasurer twice each year in July and December. The “taxable value” (TV) is the value used for property tax calculated.

When property taxes are not paid to the city or township treasurer by February 28, the delinquent taxes are transferred to the County Treasurer for collection as governed by the Michigan Compiled Law, MCL 211.78. The following section provides a brief overview of definitions common to local property taxes.

Assessed Value

State law requires that property be uniformly assessed and not exceed 50% of the usual selling price (market value), which is often referred to as the True Cash Value (TCV). Each year, the local assessing unit determines the Assessed Value (AV) of each parcel of real property based on the condition of the property on December 31 (Tax Day) of the previous year. Michigan Law MCL 211.34c requires that not later than the first Monday in March each year, the local assessor shall classify all assessable property in their jurisdictional boundaries. The definition of residential property includes parcels with or without buildings.

True Cash Value

The assessor's determination of a property's worth or what the assessor believes the usual selling price may be. A property's true cash value is usually not the same as its sale price for a variety of reasons. An assessor must determine the true cash value of a property which has sold in the same manner that the assessor determines the true cash values of properties which have not sold. Therefore, an assessor may not automatically set an assessed value or a taxable value at half of a property's selling price.

The Michigan constitution requires the uniform *ad valorem* taxation of all properties and for the determination of the value to reflect the usual selling price or true cash value. To determine true cash value, the assessor must consider a number of things, including comparable properties that have sold recently. The "sales comparison approach", compares property to other similar-sized properties in the area that have sold recently (Citizens Research Council, 2021)².

Equalization

Equalization is the process to ensure that all taxable property under a jurisdiction is assessed at the same percentage of market value, in Michigan 50% of true cash value. By definition it is the process of making property taxation equal or uniform.

State Equalized Value

The State Equalized Value (SEV) is the Assessed Value after adjustment following the County and State Equalization process. Often the AV and SEV are the same. The County Board of Commissioners and the State Tax Commission must review local assessments and adjust, or 'Equalize', them by class (Residential, Commercial, Agricultural, Industrial, etc.) if the class is

² LPD notes that in cities such as Detroit that may have limited market value sales the Assessor will use other methods than just the sales comparison approach to determine the True Cash Value. In *Pantlind Hotel Co. v. Michigan State Tax Commission*, 3 Mich.App 170, 141 N.W.2d 699 (1966) the Court held "It is the opinion of this Court that until the legislature establishes other methods for determining true cash value, three acceptable tests have been and are recognized for such determination, namely: actual cash value determined by current selling price of the property or similar properties at private sale after negotiation, adjusted reproduction cost method and capitalization of income method." Id at 176.

above or below the constitutional 50% level of assessment. This value represents 50% of the estimated market value as mandated by the state.

Taxable Value

Taxable Value (TV) is the lesser of the SEV or Capped Value (CV) for the property in a given year. TV cannot be higher than the SEV. The CV limit does not apply if you purchased your property during the previous year. The TV will be used for the calculation of property taxes.

Capped Value

Capped Value (CV) is the product of a formula that uses several numbers: last year's taxable value, additions, losses, and the Consumer's Price Index (CPI). This value is computed at last year's taxable value, minus losses, multiplied by the Consumer Price Index (rate of inflation) or 5% (whichever is lower), plus any additions.

Headlee Amendment and Proposal A

The Headlee Amendment to the Michigan Constitution in 1978, limits the total tax levy to the rate of inflation. Headlee requires a local unit of government to reduce its millage when annual growth on existing property is greater than the rate of inflation, excluding additions and losses. Consequently, the local unit's millage rate gets "rolled back" so that the resulting growth in property tax revenue, community-wide, is no more than the rate of inflation. A "Headlee override" is a vote by the electors to return the millage to the amount originally authorized via charter, state statute, or a vote of the people, and is necessary to counteract the effects of the "Headlee Rollback (Michigan Municipal League, Fact Sheet, 2016).

Proposal A, which passed in 1994, limits the annual taxable value growth of a parcel to the greater of inflation or 5 percent. In the year that a property is transferred the taxable value is "uncapped" and increases to the parcel's state equalized value. Read together, Proposal A generally overrides the impact of Headlee. But for the Proposal A uncapping feature, a per parcel taxable value cap at inflation would always reduce tax revenues lower than a local unit-wide tax revenue growth reduction to inflation since there will always be some parcels with growth of less than inflation. Headlee, however, still controls year to year growth of tax revenues and thereby mitigates the positive effect of any pop-ups. Thus, even though Proposal A may have lowered annual tax revenues below the Headlee cap for years, the Headlee formula is not a cumulative revenue benchmark. In a year when pop-up value increases would cause revenues to increase beyond the annual Headlee revenue cap, Headlee will require millage rollbacks notwithstanding the fact that the Headlee authorized revenue was not able to be levied in past years.

With these mechanics in mind, a split-rate tax proposal could be designed to base the revenues the local unit may receive in any year to what the local unit could have received from ad valorem taxes at authorized millage rates after application of the Headlee and Proposal A limitations. In that fashion, even though Headlee and Proposal A may not directly apply to this new tax, their impact on revenues could still be imposed statutorily. The more difficult issue in implementation of the proposal is how to apply the Proposal A parcel caps upon each parcel of property. Statutorily, the proposal could be written to cap the annual growth of land value and

improvement values to the Proposal A caps.³ The constitutional requirement for taxes to be “uniform upon the class or classes on which it operates” raises the question of whether Proposal A caps can be applied to a split tax system in lieu of general ad valorem taxation and still meet the “uniformity clause”.⁴

LINCOLN INSTITUTE – DETROIT FORECAST

The research included a 5-year forecast, based on a 5-to-1 tax rate ratio, with projected rate of growth at 16.3% in the true cash value from 2019 to 2024. The forecast indicated that residential properties, both owner-occupied and rental, would receive an average 18.4% reduction in property tax bills (an average savings of \$160 per year) (p.6). The study also found that almost all neighborhoods realize a tax savings. Areas with lower-value housing were projected to experience moderately greater savings (p.6).

As an example, the 2021 Total Millage Rate for Detroit is 69.5837 for a principal residence (homestead property) and 86.4416 for businesses (non-homestead). It is important to note that in addition to the Detroit General Operating Tax, it includes Debt Service, Detroit Public Schools Debt & Operating, Wayne County and State Education Taxes. It is not inclusive of Wayne County regional taxes, such as for jails, parks, zoo, DIA.

The millages used in a split rate system must fulfill two requirements: the land millage must be higher than the improvement millage (in this example five times higher) and the revenue generated in both millages must be the same as millage in a single rate system in the aggregate. We can find the appropriate millages formulaically using total taxable value for land and improvements in the City:

Property	Taxable Value	Single Rate Millage	Split Rate Millage	Tax Levy	Effective Tax Rate
Land	690.8		281.318	194.3	28.13%
Building	4460.9		56.264	251.0	5.63%
Total	5151.7	86.4416		445.3	8.64%

In millions of \$; uses tax year 2019 ad valorem taxable values.

Using Tax Year 2019 taxable values in the above example, these split rate millages fulfill both conditions. Below is an illustration of the comparison of application of a single-rate and split-rate property tax system to a single parcel of non-residential property. While both a single rate and split rate system produce the same total revenues, the amount levied on the land portion of the property is significant higher and the amount levied on the improvement portion of the property is significantly lower under the split rate system:

Property	Taxable Value	Single Rate Millage	Split Rate Millage	Tax Bill	Effective Tax Rate
Land	500		281.318	140.66	28.13%

³ A Proposal A cap calculated separately on land and improvements could result in a lower combined taxable value than if capped in the aggregate and prorated.

⁴ The uniformity clause question can also be applied to NEZs. The practical difference is that there will be parcels with higher taxes that are likely to object and challenge the split rate tax system once in place.

Building	25,000		56.264	1,406.59	5.63%
Total	25,500	86.4416		2,204.26	8.64%

Considering how the split rate millages are calculated and the example with a single parcel we can make two quick generalizations:

- A revenue neutral millage is dependent on the share of the taxable value of land to total taxable value. If the share changes, the millage needed for revenue neutrality will change.
- If the percent share of a parcel’s land taxable value to its total taxable is higher than City’s percent share, the parcel’s tax bill will go up. If lower, then it goes down (e.g. In the above example, the single parcel land TV is about 2% of total TV. For the City in Tax Year 2019, it was 13%. So, we know the parcel in the example will have a tax savings.)

SPLIT-RATE PROPERTY TAX IMPLICATIONS

- Taxing land does not penalize new investment and encourages more capital-intensive development and renovations.
- Split rate tax would be less favorable if the approach were to raise revenues without a corresponding reduction of taxes on improvements. Limitations include, if applicable:
 - The 1978 Headlee Amendment, which limits increases in property tax collection to the rate of inflation, or the millage rate city-wide is “rolled-back”.
 - The City of Detroit has a statutory limit on its ability to levy taxes and generally remains near that statutory maximum.
- A reduction of the millage rate on improvements provides the greatest immediate benefit to properties outside of the downtown area, by providing immediate tax relief and increasing the sales value of homes (p.16).
- In comparison with Neighborhood Enterprise Zones Homestead Exemption (NEZ-H), which allow for a 15-year, renewable tax exemption for property owners in designated neighborhoods, the split-rate tax applies to all property owners and is permanent.
- For residential rental properties, the tax savings could potentially convey to the renter in the form of rent relief or to the landlord directly.
- A split-rate tax system in Detroit could improve tax compliance, reduce tax delinquencies and foreclosures, and increase homeownership.
- Split-rate tax would negatively impact businesses that have significant surface parking or open storage areas.
- Critical to the implementation of the split-rate tax system is that the assessments of land value should reflect market values and not current use values.
- A prerequisite to a successful implementation is the existence of accurate and up-to-date appraisals of all land values.

LINCOLN INSTITUTE OF LAND POLICY – KEY STUDY FINDINGS

The study acknowledges that Detroit experiences high levels of property tax delinquencies, an overburdened tax foreclosure process, and low rates of homeownership. The study assessed the effects of the split-rate tax system on tax delinquency, tax foreclosures, and home ownership:

- Tax Delinquency – declines in taxable value had a positive impact on delinquency and lead to meaningful improvements in tax compliance (fewer delinquencies).
- Tax Foreclosure – reductions in taxable value reduced the likelihood of at-risk properties moving into tax foreclosure. This continued over a 3-year period, with the impact being strongest in the first year.
- Home Ownership – reductions in taxable value resulted in properties transitioning from rental to a homestead status.

The study also found that the higher the split-rate tax ratio, the effects on tax delinquency, tax foreclosure, and homeownership would be stronger (ex. 10:1 vs 1:1). The strongest impact would be experienced by fully transitioning to a land value tax. Other findings in the study included:

- Stimulated economic activity by discouraging holding on to vacant land, while encouraging capital investments in structures and improvements.
- Implementation of a split-rate tax system would likely decrease the value of land and increase the value of structures. It is important to note that the Headlee Amendment and Proposal A place limitations on the levy of property taxes.

SPLIT-RATE PROPERTY TAX RECOMMENDATIONS FOR THE CITY OF DETROIT FROM THE LINCOLN INSTITUTE STUDY

- **Implement a split-rate property tax system**, with a higher tax rate being applied to land and a lower tax rate being applied to structures and improvements.
 - Can accelerate land development and improvements to structures
 - Improves tax compliance and homeownership
- **5:1 split-rate, phased over time**
 - The model for the 5-to-1 ratio lowered Detroit’s tax rate on improvements to 57.3 mills (from 69.6202 residential).
 - This would be comparable to communities in the area and the statewide average
 - Benefits are similar to the NEZ-H program (56.3 mills).
- **Accurately measure taxable land values to reflect market values**
 - Accurate assessments of land values are essential; requires estimation of market-based land values, with regular updates.
- **For maximum impact, all units of government should be included in the split-rate system implementation**
- **Re-evaluate commercial tax abatement underwriting**
 - Tax abatements are considered to provide similar, yet less favorable financial benefits to the split-rate tax.
 - It is recommended to evaluate if adding tax incentives to a split-rate tax creates excessive tax reductions.
- **Implications for Neighborhood Enterprise Zones (NEZs) under a split-rate tax system**
 - For most properties, a 5:1 split-rate provides greater property tax relief than the NEZ-H tax exemption.
 - City should evaluate if it is worthwhile to terminate the NEZ-H program, which has limitations, for the split-rate tax, which is permanent and applies to all homeowners is more equitable.

- If the NEZ-H is retained, some certificate holders will see an additional reduction. However, some areas could expect to see an increase (Midtown, Boston Edison, Indian Village, and subdivisions southeast of Woodward and 8 Mile Road).
- **Inform local residential and commercial mortgage lenders of tax changes**
 - The increased visibility and understanding can help enhance credit access and loan size to accelerate the market response.
- **Use available land price indices or cost-approach methods to validate local sales data**
 - Accurate land valuations and valid assessments are essential.
 - Instead of solely relying on vacant land sales for determining value, take advantage of the “replacement cost-method” approach, that subtracts the depreciated cost of the improvements from the total property value.
- **Implement ways to encourage payment of back taxes to reduce existing chronic tax delinquency**
 - Combine the split-rate tax with programs that encourage payment of delinquent taxes. This leverages the benefits of a reduced tax burden derived from the split-rate taxation.

ADDITIONAL QUESTIONS/COMMENTS/CONCERNS:

- Most critical to the implementation of a split-rate tax system is the required change in the State of Michigan’s General Tax legislation. Professor Roling suggests state-wide legislation, with an opt-in/opt-out provision for local jurisdictions (Daily Detroit Podcast, 2021).
- The costs for the administration and implementation of the split-rate tax system and accurate land assessments have not been estimated.
- The City of Detroit’s Neighborhood Enterprise Zone-Homestead (NEZ-H) already has a mechanism in place to determine 2 separate tax rates – one for the land and one for the building. The ability to generate two separate tax bills per residential property is already in existence.
- City of Southfield- In Southfield, utilized a Land Valuation Approach to assess land on a basis of its “full-market value”, whether it is being used, underutilized, or not used at all, and regardless of its zoning. This is currently permitted within the State of Michigan.
 - City of Southfield hired a consultant to conduct a complete the initial reappraisal of land values. Conducts annual land reappraisals.
 - The land is valued separately from the improvements
 - Land value is based on the current use
 - Land valuation options include: income, cost or sales comparison (market value)
 - The market value is based on the neighborhood.
- What are the implications under the split-rate tax system for properties that are abandoned or derelict, if the tax savings are not applied towards property improvements?

- A limitation of the Lincoln Institute study is that there only a few major U.S. cities that have implemented the split-rate tax system. Data and comparisons are based primarily on municipalities in Pennsylvania and Connecticut, along with models or simulations.

There are a number of questions that would have to be thoroughly vetted and a determination as to what impact a switch to a split-rate tax system would actually have on taxing jurisdictions. Those questions have been delineated earlier.

In conclusion, the Split-Rate Property Tax system is worth further investigation for possible implementation in the City of Detroit. It may provide an opportunity to reduce or eliminate property tax abatements, promote density and development of underutilized land, and provide a system that appears to be more equitable in providing benefits for redevelopment. One major hurdle would be it requires the adoption of legislation changing the state's property tax code, which is not an insignificant undertaking.

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