City of Ann Arbor
Treasury Services Unit
Matthew V. Horning, Treasurer

TO: TOM CRAWFORD, CFO

FROM: MATTHEW V. HORNING, TREASURER

SUBJECT: INCOME TAX QUESTIONS POSED BY COUNCIL

DATE: TUESDAY, NOVEMBER 3, 2009

City Council had posed some questions to you regarding details of the Michigan Uniform City Income Tax and the recent income tax study performed for the City by Plante Moran. Below are answers to those questions. I have also attached the income tax FAQs for further clarification.

Q1. Please clarify qualified income, exemptions and deductibility from State and Federal income tax.

A1.

These items are explicitly defined by State law (PA284 of 1964) and IRS code. Below are some highlights:

-Qualified Income = All personal and corporate income, less exemptions

-Exempt Income

1. Social Security
2. Pensions (public & private)
3. Insurance payments
4. Annuities
5. Retirement benefits
6. Disability
7. Welfare
8. Unemployment
9. Workers' Comp
10. Interest on U.S. securities
11. Financial & Insurance Co. net profits
12. U.S. armed forces compensation
13. Pell Grants

-Deductibility

1. Michigan Income Tax: Amounts paid for city income tax are deductible from Michigan income tax up to $10,000. The amount of tax that can be deducted depends on the amount paid. If city income tax is less than $100, 20% is deductible. From $101 to $150 in city tax paid, $20 plus 10% of the portion above $100 is deductible. If city tax paid exceeds $150, $25 plus 5% of the portion above $150 is deductible.

2. Federal Income Tax: up to 100% subject to limits of Schedule A-Itemized Deductions

Q2. Please investigate validity of the number of commuters reported in the Plante Moran feasibility study.

A2.

The study used a methodology in which the number of commuters is derived from a forecasted number of total jobs and the number of residents employed within the City.

Total Jobs = Resident Workers + Non-resident Workers, therefore:

Non-resident Workers = Total Jobs – Resident Workers

The Total Jobs figure was forecasted using 2000 census data, and applying a growth rate analogous to the growth rate between the 1990 and 2000 censuses. Although this assumption seems reasonable, staff believes that, given the economic climate since 2000, the assumption of a continuous growth rate in total jobs is flawed. Data below from the U.S. Bureau of Labor Statistics provides empirical support for this view.

Year	Annual Employment (1000)
2000	201.6
2001	209.5
2002	206.3
2003	202.6
2004	203.2
2005	203.1
2006	201.7
2007	199.4
2008	195.1
2009	187.1*

* Mean through September

Utilization of a 0% growth rate in the model results in 63,496 projected commuters in 2011. The table below shows the projected revenue at four different exemption levels when the lower commuter number is used in the model.

	Exemption Level			
	600	1000	3000	3500
Revenue at 75,253 Commuters	14,242,000	13,330,000	8,773,000	7,634,000
Revenue at 63,496 Commuters	12,207,000	11,344,000	7,031,000	5,952,000
Decrease	(2,035,000)	(1,986,000)	(1,742,000)	(1,682,000)

Q3. Please clarify Council's ability to exempt various levels of total income from taxation.

A3.

-Council Authority to Exempt Taxation

PA 284 of 1964, 141.631 Exemptions.

Sec. 31. (3) For tax years beginning after 1986 and upon passage of a further ordinance, a city, as determined by its governing body, may provide for either an exemption from the tax levied under this act if that person's adjusted gross income for that tax year is less than a certain amount to be as specified by the ordinance, or an exemption in an amount to be specified by the ordinance, for a person with respect to whom a deduction under section 151 of the internal revenue code is allowable to another federal taxpayer during the tax year and is therefore not considered to have a federal personal exemption under subsection (1).

Impact of such an exemption:

Household income in Ann Arbor

Income Range	# of Households
Less than $10,000	4724
$10,000 to $14,999	2543
$15,000 to $19,999	2603
$20,000 to $24,999	2618
$25,000 to $29,999	2330
$30,000 to $34,999	2564
$35,000 to $39,999	2521
$40,000 to $44,999	2389
$45,000 to $49,999	1963
$50,000 to $59,999	3586
$60,000 to $74,999	4460
$75,000 to $99,999	5024
$100,000 to $124,999	3227
$125,000 to $149,999	1902
$150,000 to $199,999	1594
$200,000 or more	1696
Total	45,744

Therefore, the following incremental reductions to income tax revenues are projected if Council chooses to exempt all taxes on incomes less than $10,000, $15,000 and $20,000:

Minimum Income for Taxation	# of Households	% of Households	Exemption Level			
			600	1000	3000	3500
None			$ 12,207,000	$ 11,344,000	$ 7,031,000	$ 5,952,000
$10,000	4724	10.3	11,881,044	11,036,940	6,818,420	5,763,040
			(325,956)	(307,060)	(212,580)	(188,960)
$15,000	7267	15.9	11,016,271	10,201,235	6,128,055	5,109,010
			(1,190,729)	(1,142,765)	(902,945)	(842,990)
$20,000	9870	21.6	9,348,241	8,572,685	4,696,905	3,727,210
			(2,858,759)	(2,771,315)	(2,334,095)	(2,224,790)

Incremental revenue decrease based upon marginal effect above that of a standard exemption at each of the four exemption levels.

Q4. Please provide additional scenarios: Corporation owns Real Estate, Corporation leases Real Estate (gross) and Corporation leases Real Estate (triple net). Please contrast tax implications versus similar communities in the U.S.

A4.

Leases are typically written with terms that are "Gross" or "Triple Net" (NNN). In a gross lease, the property owner pays for tax, insurance and maintenance. In a triple net lease, the lessee is responsible for these costs. The table below assumes a business with a taxable income of $150,000 and a property value of $500,000.

Corporation	Lessor to Lessee Pass-through of Property Tax Savings	Income Tax	Property Tax Reduction	Tax Increase (Decrease)
Owns Real Estate		1,500	3,084	(1,584)
Leases Real Estate (NNN)		1,500	3,084	(1,584)
Leases Real Estate (Gross)	0%	1,500	0	1,500
Leases Real Estate (Gross)	50%	1,500	1,542	(42)
Leases Real Estate (Gross)	100%	1,500	3,084	(1,584)
Assuming				
Net taxable income =		150,000		
Property value =		500,000		
Exemption level =		NA		

The triple net lease situation is the same as with ownership. The gross lease scenario depends on the degree to which market forces shift the property tax savings from the property owner to the lessee.

The table below shows the relative corporate tax burdens of major university cities.

Corporate Tax Burden by Metropolitan Statistical Area (MSA), 2004

Metro Area	State	Households in MSA	Total Corporate Tax Burden by MSA ($thousands)	Average Corporate Income Tax Burden by Household	Rank (331 Total MSAs)
Boulder-Longmont*	CO	143,186	$570,657	$3,985	16
Madison	WI	197,537	$652,674	$3,304	36
Austin-San Marcos	TX	562,600	$1,783,831	$3,171	49
Ann Arbor*	MI	228,301	$717,988	$3,145	50

Note: * indicates PMSA as opposed to an ordinary MSA as defined by the Office of Management and Budget (OMB).

Source: Internal Revenue Service; Bureau of Economic Analysis; Census Bureau; Tax Foundation calculations

Q5. The model assumes landlords will pass through 50% of property tax savings to leaseholders. Please provide an analysis showing the effects of 0% and 100% pass-through. Please add a scenario for the typical student.

A5.

RESIDENT RENTER 1 SCENARIO

- Resident earns the average City of Ann Arbor Wage = $51,802 (Source: Bureau of Labor Statistics, 2007, + 1.18% per year to 2009)
- Resident rents a home with an "average" property value of $200,000
- Single resident qualifies for 1 exemption

0% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$512	$508	$488	$483
Property Taxes Paid Via Rent	$618	$618	$618	$618
Total Taxes	$1,130	$1,126	$1,106	$1,101
Tax Increase	**$513**	**$509**	**$489**	**$484**

50% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$512	$508	$488	$483
Property Taxes Paid Via Rent	$309	$309	$309	$309
Total Taxes	$821	$817	$797	$792
Tax Increase	**$204**	**$200**	**$180**	**$175**

100% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$512	$508	$488	$483
Property Taxes Paid Via Rent	$0	$0	$0	$0
Total Taxes	$512	$508	$488	$483
Tax Decrease	**($105)**	**($109)**	**($129)**	**($134)**

RESIDENT RENTER 2 SCENARIO

- Resident earns the average City of Ann Arbor Family Household Income = $104,034
(Source: Claritas, 2008, +1.18% per year to 2009)
- Resident rents a home with an "average" property value of $200,000
- 2 exemptions claimed

0% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$1,028	$1,020	$980	$970
Property Taxes Paid Via Rent	$618	$618	$618	$618
Total Taxes	$1,646	$1,638	$1,598	$1,588
Tax Increase	**$1,029**	**$1,021**	**$981**	**$971**

50% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$1,028	$1,020	$980	$970
Property Taxes Paid Via Rent	$309	$309	$309	$309
Total Taxes	$1,337	$1,329	$1,289	$1,279
Tax Increase	**$720**	**$712**	**$672**	**$662**

100% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$1,028	$1,020	$980	$970
Property Taxes Paid Via Rent	$0	$0	$0	$0
Total Taxes	$1,028	$1,020	$980	$970
Tax Increase	**$411**	**$403**	**$363**	**$353**

STUDENT RENTER SCENARIO

- Student earns $9,600 ($15/hr, 20 hr/week, 32 weeks)
- Student rents apartment with an "average" property value of $50,000
- 1 exemption claimed

0% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$90	$86	$66	$61
Property Taxes Paid Via Rent	$308	$308	$308	$308
Total Taxes	$398	$394	$374	$369
Tax Increase	**$90**	**$86**	**$66**	**$61**

50% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$90	$86	$66	$61
Property Taxes Paid Via Rent	$154	$154	$154	$154
Total Taxes	$244	$240	$220	$215
Tax Decrease	**($64)**	**($68)**	**($88)**	**($93)**

100% Pass-through

Exemption	**$600**	**$1,000**	**$3,000**	**$3,500**
Income Tax	$90	$86	$66	$61
Property Taxes Paid Via Rent	$0	$0	$0	$0
Total Taxes	$90	$86	$66	$61
Tax Decrease	**($218)**	**($222)**	**($242)**	**($247)**

Q6. Please confirm ballot language requirements.

A6.

This question will be posed to the Michigan Attorney General. We believe the tax rates are required language, and that other variables such as minimum qualifying income and exemption level are set by Ordinance and/or Resolution.

Q7. Please clarify process for adoption including a timeline.

A7.

12/21/09	Income Tax Ordinance First Reading
1/4/10	Income Tax Ordinance Second Reading &
	Pass ordinance adopting Chapter 2 of PA 284 of 1964 in whole or by reference
2/15/10[A]	Referendum period expires (may be irrelevant pending direction from the Michigan Attorney General)
2/22/10 [A]	Clerk report to Council regarding referendum (if necessary)
4/8-4/23/10 [A]	Referendum Election (if necessary)
5/4/10	Election
5/17/10	Pass ordinance adopting Chapter 2 of PA 284 of 1964 in whole or by reference (if 11/2/09 passage deemed void)
	Pass amendments, if necessary, to Income Tax Ordinance (if 11/2/09 passage deemed appropriate)
5/18/10-12/31/10	Establish Income Tax Office, purchase City Tax ™ software, participate in City Tax ™ user group, hire staff, establish business registration process, generate forms, establish withholding processes, establish reporting and compliance processes, & otherwise prepare for 1/1/11 institution of City Income Tax.

[A] The question of whether the referendum process remains valid post-Jan. 1, 1995 will be posed to the Michigan Attorney General

City of Ann Arbor

Income Tax Feasibility

Frequently Asked Questions

Municipalities in Michigan are statutorily required to provide certain services such as police, fire, district court, etc. These services are funded through a variety of revenue sources. The two most significant revenue sources are operating millage (property tax) and state revenue sharing. The Michigan economy has resulted in declining property values, thereby reducing property tax revenues. Lower state sales tax collections are also reducing state shared revenue.

During the past several years, the City of Ann Arbor has made significant reductions in costs, including a 25-percent reduction in the number of employees, without a substantial reduction in services. Despite these cost reduction efforts, the revenue available to the city is declining at a rate which will impact critical services in the near future.

The City of Ann Arbor is a vibrant and engaging community that has been recognized as a top destination to live and work. The University of Michigan plays a central role in the vibrancy of Ann Arbor as do the many parks and recreation activities. Unfortunately, Ann Arbor parks, the University of Michigan plus other tax-exempt organizations comprise 40 percent of the total real-property ownership in the city, leaving the remaining 60 percent to pay for most general-fund city services.

An income tax could potentially help to diversify and stabilize the city's revenue stream, and shift some of the tax burden from property owners and residents to non-residents. City Council requested an update to a 2004 income tax study to help identify solutions to the city's shrinking tax revenue situation. The full report and Frequently Asked Questions (FAQs) are available on the City's website at www.a2gov.org.

Below are key points for voters to consider regarding a potential Ann Arbor City income tax.

- Under PA 284 of 1964, local voters must approve a local income tax and the tax is limited to 1 percent on residents and corporations and 0.5 percent on non-residents.
- If an income tax is authorized, City Council would also have to establish an exemption level which taxpayers can use to reduce their taxable income. Other Michigan communities utilize between $600 and $3,000 per eligible exemption.
- Ann Arbor's City Charter requires that the adoption of an income tax must be accompanied by a repeal of the city's largest millage – its Operating millage. A resident with qualifying homestead property would see a 14-percent reduction in his or her property taxes. [Since the city only receives a portion of the total property taxes collected, the city would see a 37 percent reduction in revenue from property taxes.]
- Administration of an income tax is estimated to cost approximately $3 million annually.
- Initial estimates suggest the city could recognize an additional $8.8 million annually, net of administrative fees, by adopting an (1% resident / 0.5% non-resident) income tax with a $3,000 exemption level.

- Adoption of an income tax would require the drafting of ballot language, approval of the language by the Michigan Attorney General, and a vote of Ann Arbor residents to amend the City Charter.
- Local income taxes are deductible on federal tax returns if you itemize, and a portion of income tax paid to Michigan cities is deductible from Michigan state income tax.
- There are 22 other Michigan communities who utilize a local income tax.

Frequently Asked Questions:

1. Why should residents *consider* approving an income tax?
   Answer: Michigan's property tax laws limit revenues to municipalities. These limits have been in place for decades and have already created budget shortfalls. Now, lower property values and declining state revenue sharing are jeopardizing basic services provided by many communities. The following are a few reasons why Ann Arbor residents should consider approving an income tax:

   - The city is in a very difficult financial situation. Reductions in important city services are planned to be implemented in 2010 and 2011 in order to balance the budget.
   - Two of the many things which contribute to Ann Arbor being a desirable place to live and work are the University of Michigan and the city's extensive park system. Both of these properties are tax exempt and are the largest contributors to the fact that 40 percent of the property in Ann Arbor is tax exempt.
   - As a consequence of state tax limitations, the millage for property tax may not be increased without the vote of the people. If the electors of the City of Ann Arbor voted to approve a Headlee rollback, the city's operating millage would increase from 6.1682 to 7.5000 mills.
   - State law does not permit cities to institute other types of taxes such as a sales tax or an entertainment tax (ie. ticket tax on sporting events).
   - An income tax, which supplements a lower property tax, would rebalance the tax burden from just commercial and residential property owners to include the non-resident workforce.
   - City Council commissioned a feasibility study of the potential effects of instituting a city income tax in lieu of an operating tax millage. This study was completed and indicates a new income tax could raise from $3 to $12 million in additional annual revenue.
   - The city has approximately 63,500 non-resident commuters who utilize some city services but do not pay local taxes.
   - The many organizations that are exempt from paying property taxes would, through their employees, begin to pay a portion of the costs of city services.

2. Would property taxes be eliminated if an income tax is approved?
   Answer: Only the General Operating millage is eliminated. All remaining millages, including voter approved millages for land acquisition (green belt & parks), street resurfacing, solid waste and Parks would not be affected. Although the city collects property taxes for other jurisdictions like the schools, library, county, and the state, the City receives approximately 28 percent of the total monies collected. The other taxing jurisdictions would not see any reduction in property tax revenues. A resident with a homestead exemption would see approximately 14-percent reduction in property taxes while the city would incur a 37-percent reduction in property tax revenues.

3. Will I pay more in total taxes (property tax plus income tax)?
   Answer: It varies depending on individual circumstances. The attached study includes examples of how individuals may be impacted. These examples include a resident who owns and lives in their home, a resident who rents, a resident who qualifies for a senior or disabled exemption, and a non-resident who commutes to work in Ann Arbor.

4. How would a residential rental property owner be affected?
Answer: The rental property owner would see a reduction in property taxes. The rental resident would incur an income tax of 1 percent. It's uncertain to what extent market pricing pressures will or will drive landlords to pass the property tax reduction on to renters.

5. How will I as a senior citizen who lives on a fixed income be affected?
Answer: Senior citizens and the disabled would receive an extra income tax exemption. If a person in this category owns their home, they will see a reduction in their property taxes and an increase in income taxes (but only after deducting a personal exemption and the extra exemption. If a $1,000 exemption level is approved, a person would be able to deduct $2,000 from taxable income before applying the 1 percent tax rate). It is important to note that the distributions from Social Security, pensions (public & private), annuities, retirement benefits, disability and welfare are entirely exempt from city income tax.

6. If an income tax is approved, how would it be collected?
Answer: Companies would start withholding income taxes from individuals' paychecks and/or quarterly payments could be made. A local income tax form would be required to be filed by April 15. If approved by voters, the earliest an income tax would take effect would be January 2011, with tax filing due by April of 2012.

7. How much will an income tax raise?
Answer: If an income tax is approved by the voters, the City Council would also need to establish the exemption (or deduction) level. The amount of additional revenue raised would depend upon whatever exemption level is approved. The feasibility report prepared by Plante Moran has several scenarios which could be considered ranging from $3 to $12 million.

8. What did the income tax study find and where can I read the report in its entirety?
Answer: The full report is available on the city's website at www.a2gov.org.

9. What services would the additional revenue from an income tax support?
Answer: The proceeds of an income tax, which would not be available until July 2011, would support the same activities the general operating levy supports.

10. What's the average taxable income for Ann Arbor residents and what is the average taxable value of residential property?
Answer: The average taxable value of residential property in Ann Arbor is $110,000.

    The taxable income for residents is not available but the following household income is available from the 2000 U.S. Census:

HOUSEHOLDS BY INCOME

Level of Income			Number of Households	Percent
Less	than	$10,000	4,724	10%
$10,000	to	$14,999	2,543	6%
$15,000	to	$24,999	5,221	11%
$25,000	to	$34,999	4,894	11%
$35,000	to	$49,999	6,873	15%
$50,000	to	$74,999	8,046	18%
$75,000	to	$99,999	5,024	11%
$100,000	to	$149,999	5,129	11%
$150,000	to	$199,999	1,594	3%
$200,000	or	more	1,696	4%
Total			45,744	100%

Median Income $46,299

11. Instead of an income tax, how much would a Headlee override provide in additional property tax revenue if the general operating millage was increased to its original maximum in the City Charter of 7.500 mils?
    Answer: If the General Operating levy was increased to the maximum established in the City Charter, it would provide approximately $6 million in additional revenue.

12. If the income tax isn't passed what city services will be impacted?
    Answer: Any service reductions, if necessary, would be at the discretion of Council.