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We have compiled the accompanying Income Tax Feasibility, of the City of Ann Arbor for fiscal years 2005 through 2009, in accordance with attestation standards established by the American Institute of Certified Public Accountants.

This forecast does not present all significant financial measures that would be present in a complete set of financial statements (statement of net assets, statement of revenue, expenses and changes in net assets, and statement of cash flows). Accordingly, this forecast is not designed for those who are not informed about the City's financial position, results of operations and cash flows.

A compilation is limited to presenting in the form of a forecast, information that is the representation of management and does not include evaluation of the support for the assumptions underlying the forecast. We have not examined the forecast and, accordingly, do not express an opinion or any other form of assurance on the accompanying statements or assumptions. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

The accompanying forecast and this report are intended solely for the information and use of the City of Ann Arbor and is not intended to be and should not be used by anyone other than these specified parties.

Plante and Moran, PLLC

November 11, 2004

# CITY OF ANN ARBOR, MICHIGAN

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### **Project Objective**

The City of Ann Arbor, Michigan ("City") is conducting a study of the potential effects of instituting a city income tax in lieu of an operating property tax millage. The purpose of this study is to estimate whether an income tax is a feasible option for the City and to assess the potential burden shift between the different classes of taxpayers: residents, non-residents, and businesses.

The City's charter requires that the general operating property tax millage be eliminated if an income tax is implemented. Therefore, it is important to ensure that an income tax would generate enough revenue to offset the loss in general operating property tax revenue.

### **Project Methodology**

To meet our objective, statistical information about the City's population, worker demographics, residential household income and business income from various sources was gathered. Sources included the City, United States Census Bureau, Michigan Department of Treasury, U.S. Bureau of Labor Statistics, employer surveys, surveys of other cities which assess income tax, and market research companies. Once the source data was obtained, certain assumptions were made in order to estimate the revenue that would be generated under an income tax system and to project revenues over the next five years.

Historical data about the current property tax system was compiled by the City. Using growth rate assumptions made by City personnel, revenue that would be generated from the current property tax system was projected over the next five years.

After preparing the income tax and the property tax models as described above, the results of each were compared. Not only the total revenue which would be generated from each system, but the percentage of each revenue type that would be paid by the different classes of taxpayers (residents, non-residents, and businesses) were compared.

The analysis has been developed using the best available information concerning financial and demographic trends and conditions. As mentioned above, each model was developed using certain key assumptions and should not be evaluated without a thorough understanding of those assumptions. The assumptions and the accompanying rationale are documented in later sections of this report.

All assumptions are the responsibility of the City of Ann Arbor's management based on their best judgment at the time of the study. It is possible that the forecasted results may not be achieved because events and circumstances frequently do not occur as expected.

### **Findings**

Based on the assumptions outlined in this report, an income tax using maximum tax rates and minimum exemption allowances allowed by Michigan law could generate approximately \$45 million, net of estimated administrative costs. The City's operating property tax millage is estimated to generate approximately \$26 million of revenue in fiscal year 2005. Therefore, an income tax could generate sufficient revenue to replace the City's operating property tax millage as a revenue source.

For comparison purposes, income tax revenue using alternative exemption levels of \$1,000 and \$3,000 has been calculated. See Appendix A for the results of these calculations.

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## Income Tax Feasibility Study Revenue Summary – Property Tax System November 2004

### Property Tax System – Current State

#### Property Taxes and Millage Rates

The City currently has a property tax system which generates revenue from property owners in the City limits. The revenue is calculated by multiplying the taxable value of property by the millage rates. The following millage rates have been approved by the City for the 2004 tax year:

Operating	6.2125
Benefits	2.0948
Refuse	2.5137
Debt service	0.6000
Street repair	1.9693
Parks development	0.4601
Parks maintenance	0.4692
Parks acquisition	0.4871
AATA	2.0948
Total	<u>16.9015</u>

Under the City charter, if the City implements an income tax, it must eliminate the operating property tax millage (6.2125 mills). The City may continue to levy special-purpose millages; however, the operating millage must be reduced to zero. Since the special-purpose millage rates can only generate revenue to be used for specific expenditures, they are not included in any aspect of this study. All discussion and reference to “property tax revenue” in the remainder of this report will refer only to the operating millage.

#### Significant Factors Affecting the Property Tax Model

The following factors have an affect on how the property tax is calculated and projected:

- Headlee Amendment
- Proposal A
- Tax Increment Financing District
- Administration Fee

Under State law, the Headlee Amendment and Proposal A have a significant impact on the rate of revenue growth that can be achieved through property taxes.

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## **Income Tax Feasibility Study Revenue Summary – Property Tax System November 2004**

### The Headlee Amendment

The Headlee Amendment limits the growth of property tax revenue by controlling how the City's maximum authorized millage rate is calculated. The maximum authorized millage rate is rolled back when growth on existing City property is greater than inflation, hence limiting the increase in revenue to the rate of inflation.

### Proposal A

Proposal A limits the increase in taxable value of property to the lesser of inflation or five percent annually. While the state equalized value (SEV) continues to grow with the market, the taxable value is limited by Proposal A. When property is sold or transferred, the taxable value is reset to SEV in a process referred to as "uncapping." This process results in an increase in the taxable value base for the City, however, the uncapped values are factored into the Headlee calculation and can cause a rollback.

### Tax Increment Financing District

Another matter which affects property tax revenue is the existence of a tax increment financing (TIF) plan for the City's Downtown Development Authority (DDA). Under the TIF plan, the DDA district is able to "capture" a portion of property taxes levied by the City. In other words, of the total property tax revenue collected by the City, the DDA will receive a portion of the revenue for its own use. The taxes captured by the DDA have been factored into the model.

### Administration Fee

An additional source of revenue generated under the property tax system is an administration fee of 1% of the total taxes levied on every tax bill. Property taxes are charged not only by the City, but by other units of government, including Washtenaw County, Ann Arbor Public Schools, Washtenaw Community College, Ann Arbor Public Library and the Intermediate School District. The City acts as an agent for the other units of government by billing and collecting the property taxes on their behalf. This administrative fee is charged by the City to cover its costs of administering property taxes on behalf of the other units of government. In the event that the City's operating millage is eliminated, the related administrative fee on the operating millage would be eliminated as well.

### Assumptions – Property Tax System

With assistance from personnel in the City's Assessing Department, assumptions about the growth of existing property, growth of new property, the rate of transfers of existing property, and the factors affecting the DDA capture were made. These assumptions were necessary in

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The assumptions used in the property tax model relating to the ad valorem roll are summarized as follows:

Factor	Growth Rate Assumption
Existing real property	7% per year
Existing personal property	(1%) per year
New property, net of losses	1.45% in 2005, decreasing by .05% each year thereafter
Rate of transfers of existing property	1.80% in 2005, increasing by .05% each year thereafter
Growth of DDA capture	6% per year

No additions to, and no significant growth of, the industrial facilities tax roll (IFT) were assumed.

The model begins with actual taxable values and state equalized values for the 2004 tax year and uses the assumptions to project revenue over the next five years. Effects of the Headlee Amendment and Proposal A are factored into the model.

### Classes of Taxpayers

In order to calculate the portion of property taxes which are paid by residents vs. businesses (non-residents do not pay property taxes), the makeup of the 2003 taxable values between homestead and non-homestead properties was compiled. Since a taxpayer must use property as a principal residence in order to qualify for a homestead exemption, the homestead totals are assumed to represent the residents of the City. Homestead properties represented 51.62% of the total taxable value, while non-homestead properties made up the

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## **Income Tax Feasibility Study Revenue Summary – Property Tax System November 2004**

### Affect on Downtown Development Authority

According to the current model, the DDA is projected to receive between \$500,000 and \$640,000 per year over the next five years from the City's operating property tax levy. In the event that the levy is eliminated in favor of an income tax system, the DDA would lose this revenue.

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## **Income Tax Feasibility Study Revenue Summary – Income Tax System November 2004**

### **Income Tax System – Proposed/Future State**

An income tax would be assessed on the taxable income of residents and corporations in the City, as well as the salaries and wages earned in the City of Ann Arbor by individuals who do not live in the City.

Under the State's Uniform City Income Tax Act (UCITA) (Public Act 284 of 1964, as amended) the voters must approve the imposition of an income tax. The maximum tax rates that can be assessed are 1% on residents and corporations and 1/2% on nonresident individuals. The rates can be lower; however, the nonresident rate cannot exceed 1/2 of the resident rate. This model was prepared using the maximum allowable rates, which are the most common rates among other cities which impose an income tax.

UCITA provides that a taxpayer is allowed a minimum deduction from income of \$600 for each personal and dependency exemption (as determined under the federal internal revenue code). Additional exemptions are allowed for taxpayers who meet certain qualifications, such as being 65 years of age or older, blind, deaf, or totally and permanently disabled. For comparison purposes, three models using different exemption rates: \$600, \$1,000, and \$3,000 have been prepared.

Another provision of UCITA specifies that residents who pay income tax to another city be allowed a credit for the amount paid to that city. Given the City's location compared to other cities that impose an income tax, the model gives consideration to residents who work and pay income taxes in the City of Detroit.

In preparing the income tax model, taxpayers were segregated into the following categories:

- Individuals who live and work in the City of Ann Arbor
- Individuals who live in Ann Arbor, but work elsewhere (non-taxing City)
- Individuals who live in Ann Arbor, but work in Detroit (taxing City)
- Individuals who work in Ann Arbor, but live elsewhere ("commuters")
- Corporations

Since the City is the home of a large university, it is appropriate to point out that in other income tax cities, students are generally treated as non-residents. Their residency is where their permanent home is (the place they will return to whenever they go away). An exception to this treatment is if a student registers to vote in the City, in which case they would be treated as a resident for income tax purposes.

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## Income Tax Feasibility Study Revenue Summary – Income Tax System November 2004

Data was gathered from the U.S. Census Bureau (2000 Census) in order to determine how many people were in each of the “individual” categories above. Once the number of individuals in each category was known, the amount of taxable income for each category was estimated.

### Estimate of Taxable Income:

**Individuals who live in Ann Arbor:** Residents of the City are taxed on their taxable income, regardless of where it was earned. The amount of income subject to tax was obtained from the State of Michigan Department of Treasury. By multiplying the ratio of residents in each of the categories above by the income subject to tax for the entire City, the taxable income for each category of residents was calculated.

In addition, for the residents who work in the City of Detroit, an estimate of the credit for taxes paid to another city was made. The average salary for jobs in the Detroit area, based on data from the U.S. Bureau of Labor Statistics, was multiplied by the Detroit non-resident tax rate to calculate the average credit per worker. The average credit per worker was then multiplied by the number of residents who work in Detroit to determine the total credit for all residents who work in Detroit.

**Commuters:** Commuters are taxed on their salaries earned in the City. To estimate income subject to tax for commuters, the number of commuters was multiplied by the average salary for jobs in the Ann Arbor area, based on data from the U.S. Bureau of Labor Statistics.

**Businesses:** To assist in the estimation of income from corporations, seven cities that impose an income tax were surveyed. Statistical data about tax collections, the number of returns filed annually, the cost of administration, and the timing of collections was collected. Four of the seven cities responded to the request. Using the data obtained from the surveys, combined with corporate sales data obtained from the marketing research company Claritas, Inc., the average tax collections as a percentage of sales was calculated. A ratio to corporate sales of the City of Ann Arbor to estimate income tax from corporations was then applied.

### Estimate of Exemption Deductions:

For each of the categories of individuals, an estimate was made about personal and dependency exemptions to be claimed. The number of individuals in each category was multiplied by the average family size, based on the 2000 census; the result was multiplied by exemption rate used in each model (\$600, \$1,000, and \$3,000).

An estimate of additional exemptions for individuals over 65 was also made. The percentage of senior residents who work was calculated using data from the 2000 Census and the Current

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Population Survey; this percentage was multiplied by the exemption rate used in each model (\$600, \$1,000, and \$3,000).

### Growth/Projection Assumptions

In building the income tax model, the following assumptions were used in projecting income tax revenue over the next 5 years:

Data	Growth Rate Assumption	Source of Assumption
Population	1.87% over next 5 years	Claritas, Inc.
# jobs in Ann Arbor	1.50% per year	U.S. Bureau of Labor Statistics
Average annual salary	1.50% per year	Claritas, Inc.
Taxable income for residents	1.50% per year	Claritas, Inc.
Worker ratio (resident workers, commuters, etc.)	Assumed stable ratio throughout the model	N/A

### Administration Costs

As with any revenue-generating program, a variety of costs are associated with having an income tax. There are costs related to the start-up of the program, such as putting the issue out to vote, establishing an ordinance, and creating forms and instructions for each class of taxpayers. Ongoing administration costs include processing the annual returns and related payments/refunds, processing quarterly estimated tax payments, registering employers for withholding, and processing the related quarterly withholding returns. Additional costs should be considered for enforcing the income tax as well. The average administration cost for the cities that replied to the survey was 3.11% of collections.

### Revenue Projections

Based on the above assumptions, it is estimated that an income tax would generate the following revenues, net of administration costs, over the next five years (assuming a 1% resident/corporate tax rate, 0.5% non-resident and \$600 exemption level):

2005	\$44,597,000
2006	46,250,000
2007	47,969,000
2008	49,758,000
2009	51,622,000

### **Historical Comparison: Tax Base**

Moving to an income tax increases a community's dependence upon the health of the general economy. The chart on the following page compares the taxable value of property versus the taxable income of residents and non residents for the City of Ann Arbor. It is important to note that the business income is not included in the taxable income estimate.

Property taxable value was provided by the City. Taxable income was based on taking 2.86% of the State AGI for the years of 1992 through 2002. State AGI was provided by the Michigan Department of Treasury and the 2.86% value was determined by comparing the taxable value developed in the model to the State 2002 AGI.

