TO: Howard Lazarus, City Administrator

FROM: Tom Crawford, Chief Financial Officer

DATE: October 3, 2016

SUBJECT: Income Tax Feasibility

The City has on several occasions considered the option of instituting an income tax in the City of Ann Arbor. State law requires the decision of implementing an income tax to be voted on by the City's residents for approval. City Charter further requires that if an income tax is adopted that the City's general operating millage (presently 6.1120), which generates $32.4 million per year for the General Fund, be eliminated.

The last official income tax feasibility review was performed by Plante Moran in July 2009. It was pointed out in their analysis that an income tax, depending on the parameters utilized, may generate net new funds for the City after eliminating the general operating millage. At your request, staff updated the 2009 report for the latest readily available information. In doing so, staff utilized the financial models Plante Moran developed at the prior engagement. Mr. Horning (City Treasurer) performed most of the analysis. Below is summary of the salient points from staff's update.

Background:
Under Michigan law, City's have three primary variables they may establish if an income tax is approved by residents.

1. Tax rate – a maximum of 1% for residents and 0.5% for non-residents is permitted.
2. Amount for exemptions – a dollar amount for each exemption may be established. Typically, this has ranged from $600 to $3,000. Examples of exemptions are a standard taxpayer, dependent, senior citizen, etc.
3. Minimum income level – this establishes the level of income at which the income tax starts being applied. Examples could be $0 (all income) or $20,000 (to relieve the lowest earning residents from income taxes).

Assumptions:
The feasibility model developed by Plante Moran required a number of assumptions. Staff updated the following assumptions with the latest information:

- Population level – utilized US census through 2015 and SEMCOG estimate for 2016. Projections assume no population growth.
- Percent of population in the labor force – utilized US census and assumed flat for projections.
- Percent of workers working in Detroit – revised to reflect latest SEMCOG estimates.
- Number of senior citizens – revised utilizing SEMCOG 2015 data and their 2020 trend assumption.
- Inflation – utilized most recent ten-year average for projections.

Results from the Model:
The revised results from the feasibility model indicate that between $5.1 million and $11.3 million in net new revenue could be collected with an income tax. The $5.1 million results from a minimum income level of $20,000 and exemption level of $3,000. The $11.3 million results from a minimum income level of $20,000 and exemption level of $600. Both scenarios assume tax rates of resident/commercial of 1% and non-resident of 0.5%. A variety of net new revenue estimates can be obtained by changing the above parameters.

Other Factors to Consider:
There are a number of complicating factors when considering adopting an income tax and eliminating the City's general operating millage. Some of these include:

- DDA TIF capture – the DDA presently captures approximately $6.3 million/year in total TIF capture. Approximately $1.4 million comes from the city's general operating millage. Elimination of this millage would reduce TIF resources to the DDA. While DDA debt obligations could continue to be funded, reducing this amount would affect their ability to do other projects & grants.

- SmartZone TIF capture - the city's SmartZone has a statutory limit on how much in school taxes may be captured in relation to local taxes. There isn't clear guidance from the State on how this limit is calculated. However, elimination of this millage may in some cases also reduce TIF resources to the SmartZone.

- Brownfield TIF capture – the city occasionally approves brownfield projects that utilize TIF capture for environmental remediation and other permissible developer expenses. Elimination of this millage would result in longer payoff periods and/or incomplete payback.

- Expenses for Administering an Income Tax – the State will not process local income taxes and remit payments. Consequently, the Plante Moran study looked at a variety of communities' actual expenses and determined approximately 7.7% of revenues as a reasonable expense projection for a local unit to incur to fully administer a local income tax. This would equate to approximately $3 million for Ann Arbor. [Note: in the projections of net new revenue in the above "Results of Model" section, this expense is already netted out of the projections.]

- Headlee override is less expensive to collect – for comparison purposes, if a Headlee override was approved by voters instead of an income tax, there would be no additional costs incurred to collect new revenues. If a Headlee override was approved for the 2017 tax year, we estimate that it would generate an additional $7.7 million.

- Declining net new revenues – based on the assumptions utilized by Plante Moran and updated by staff, the amount of new net revenue declines approximately $300k per year because income tax receipts are projected to grow slower than property tax receipts (1.2% vs. 2.4%). Consequently, depending on which assumptions are used there is a future date that an income tax would generate less than keeping the general operating millage.

- Budgeting and cash management is more difficult – Ann Arbor presently collects most of its property tax revenues at the beginning of the fiscal year. Because property valuations are completed prior to budget adoption in May of each year, the city's revenue receipts are fairly consistent with adopted budgets. However, if an income tax is approved, a major portion of the general fund's revenue would be collected during the year with a significant portion being collected mid-year. This makes it more difficult to project and budget revenues, which may result in mid-year budget adjustments to expenditures in the future. If approved, it would be advisable to establish a rainy day income tax reserve to help the city manage through a more volatile revenue environment. This is even more critical for cities in Michigan since the funding mechanisms for municipalities have resulted in reduced resources available to deliver services.

- Shifting tax burden of constituents – the reduction of property taxes and imposition of an income tax may make home ownership more affordable to lower income families. In addition, depending on the scenario chosen, net new revenue may come from non-residents instead of residents. However, the tax burden shift within the existing community is hard to accurately project. For example, residents in total may pay more in total taxes and commercial entities less. Also within the residential group, renters may see an increase in total taxation if landlords don't pass through reductions in property taxes as reduced rent. This could be harmful to affordability for lower income families. Commercial businesses will have a variety of impacts depending on whether they own the property, lease the property "gross" or lease the property "net" of taxes.

- Shifting incentives to live in Ann Arbor – since non-residents are taxed less than residents, workers in Ann Arbor have some modest incentive to live outside the city. For the City organization itself where some employees already find it challenging to afford to live in the community, an income tax may make it more challenging financially. In addition, an income tax may affect the City's ability to recruit employees.

The above analysis was based on income tax data from the State prior to 2009. If City Council desires to further explore this option, it is advisable to engage Plante Moran to revise this analysis using newer income tax information from the State. We estimate that this would cost approximately $30,000.

If you have additional questions, please let me know.