Planning Ahead – Tax Caps May Be Here to Stay
By Gary Malone, CPA, Partner

It wasn't surprising that the 2010 Indiana General Assembly session gave the green light to place a public question on the November ballot asking voters to weigh in on making the new property tax caps part of the Indiana Constitution. It is too early to say what voters will do, but given the anti-property tax sentiment we often hear from taxpayers, local governmental units and school districts should plan for the possibility that property tax caps may be here to stay.

Circuit breaker property tax credits limit the total property tax bill of each taxpayer to a fixed percentage of the property's value, before deductions. Once a property taxpayer reaches this limit, they pay no more in property taxes. In effect it creates a "hard cap" on total effective property tax rates. The resulting shortfalls in property tax collections are shared among all taxing units in proportion to their respective tax rate.

Of course the tax caps are still relatively new; most local governments and school districts are still adjusting to the caps – and some may not have experienced the full effect just yet.

Compounding the financial challenge for most cities and towns is that the new 35% homestead exemption is reducing property tax revenues from fixed rate funds, such as cumulative capital development funds, by 10 to 20%. And because current economic conditions have decreased income taxes receipts at both the state and county level, it has given governments less income for operating expenses, capital expenditures and property tax relief. Less funding available for property tax relief causes you to lose more revenue to property tax caps – becoming a self-perpetuating cycle.

Revenue for all taxing entities may also be adversely affected by trending if market value assessments have been reduced, property tax appeals, property tax collection delays or property tax delinquencies.

If your entity's income is being reduced by property tax caps, some of your options include:

- Manage revenues efficiently
- Find opportunities for cost efficiencies
- Consolidate services
- Manage your capital expenditures
- Grow your tax base

Since local governmental units can't borrow or increase property tax rates to replace the shortfall in revenues, it is essential for local governmental units and school districts to predict the amount of credits to be allocated to each of your funds. For a variety of reasons, projections from the State have been unpredictable at best. Even if revenue loss projections were accurate statewide, your area might deviate significantly from state averages.

Your budget must recognize that not all of the property taxes levied will be collected. You need a method to predict these shortfalls while you're in the budget preparation process, because actual amounts from the county auditor will not be available until tax bills are prepared.

Beyond the annual budgeting process, you will need to develop a forecast of revenues and expenditures for the next three to five years to identify potential revenue shortfalls. Consider managing your budget to achieve a targeted fund balance by year end to give you a cushion to deal with any volatility in revenue. The targeted fund balance should reflect adequate working capital, debt service requirements and capital plans. It should also consider the uncertainly of future property tax collections and income tax receipts.

You will need to prioritize your needs. For example, if you need to borrow money for capital projects, you'll need to establish whether a new debt levy will be <u>inside</u> these limits (which may cause you to hit property tax caps) or if it is better to seek voter approval of the new levy through a referendum.

Projects under $2 million may be funded by property tax supported bonds. That debt service, however, will fall within the circuit breaker tax cap limits. Bond repayment approved by a voter referendum is outside of the tax caps.

As revenue from state sales tax lagged at the end of 2009, we saw a number of school districts put public questions on the May primary ballot, asking voters to approve local property taxes for additional operating revenue.

We will probably see an increase in referendums as the full impact of property tax credits is felt – not just from schools, but from libraries and other governmental units.

What happens when your assessed value goes down?

When the Indiana General Assembly began discussing the use of property tax caps, there was a widespread belief that property values would continue to increase as they had for many years. We now know that's not the case. We have seen declining property values throughout the state in the past few years. Not only did home values decline because the housing bubble burst, commercial properties declined in value as well. As manufacturing facilities and retail locations closed, they were reassessed with lower values, and the equipment housed in factories was often relocated or devalued. No one fully contemplated these declines in property value when property tax caps became effective.

When property values drop, three things happen:

1. **If you are a taxing unit with a fixed tax rate – such as a school capital projects fund, your revenues are reduced.** In the case of the school capital projects fund, you have less money to make improvements to your school district.

2. **If you have increasing tax levies, that growing tax levy gets divided by a declining tax base to compute the tax rate.** Ideally your property value and your levies should grow at the same rate, and that's just not happening right now. Even if your tax levies remain the same, it will take a higher tax rate just to raise the same amount of revenue. For example, if you had a total tax rate of $2.80 and your tax base declines by 10%, your tax rate will need to grow to $3.08 just to collect the same tax levy.

3. **As tax rates grow and property values decline, you lose more revenue to property tax caps.** The maximum property tax a homeowner with a $100,000 home can pay is $1,000. If that property value declines to $90,000, their maximum tax declines to $900. You are receiving less tax because the home declined in value, but the value of services provided to that homeowner did not decline.

The simple result is that most units of local government will not be able to collect the amount of tax revenue they've had in past.

Forecasting your revenue in this declining property value environment is essential to plan for this new reality.

If you are unable to bring your costs in line with lower anticipated revenue, your options include finding other revenue sources to supplement property tax, making process improvements (including delivering services jointly with other taxing units), or changing the types or quality of public services offered.

Unanticipated side effects

Property tax caps have three side effects you may not have anticipated.

1. Tax caps will increase dialog with your end users. Living with property tax caps for the long haul will force all governmental units and school districts to do a better job of communicating with constituents. Voters will have the ability to decide whether projects get funding. So it behooves you to explain budgets and needs and get public input long before a financial issue gets to the voting booth. It also presents the opportunity to involve your constituents in some strategic planning about service expectations. How many police officers do we need? What do we want our fire department response time to be? Can we get by with less snow plowing or fewer street lights? Is it acceptable to have fewer course offerings or larger class sizes? Your constituents need to be educated and have a say in these difficult decisions <u>before</u> it becomes a critical issue or a question at the ballot box.

2. Tax caps may make you more creative. This option does not apply to school districts, but local governmental units may wish to change their mix of local income taxes to increase spendable tax revenue without increasing income tax rates. For example, eliminating the County Option Income Tax (COIT) Homestead Credit if you have one will increase your circuit breaker tax credits, but it will provide more usable revenues. Replacing a portion of a CAGIT tax with an EDIT tax may provide more usable tax dollars. Shifting LOIT credits from Homestead Credits to either Qualified Residential Credits or Uniform Credits may reduce revenue loss from circuit breaker tax credits. Or eliminate the CEDIT inventory replacement rate used to provide additional homestead credits and exchange it for other local option income taxes. These changes may sound like a shell game, but they are perfectly good tools to benefit your operations without increasing rates for taxpayers.

3. Tax caps will increase your awareness of what other taxing units are doing. Now more than ever, local taxing units and school districts are in this situation together. One unit raising its tax rate could trigger tax caps and reduce income for all other units. You can call this keeping an eye on your competitors for tax revenue – or approach it in a spirit of friendly cooperation, but one way or another you need to know what others have planned. Because of this increased interdependence, you'll be spending more time getting to know other governmental units.

If you would like help in projecting the effect of property tax caps in your area, strategic planning or exploring options to replace lost revenue, please contact us at footnotes@umbaugh.com.