Montgomery County Council

Committee: Directly to Council
Committee Review: N/A
Staff: Gene Smith, Legislative Analyst
Purpose: Review – straw vote expected
Keywords: Taxes, FY21 Budget

AGENDA ITEM #6
May 11, 2020
Worksession

SUBJECT

Setting real property tax revenues – Charter Limit calculation

EXPECTED ATTENDEES

Mike Coveyou, Department of Finance (Finance)
Rich Madaleno, Office of Management and Budget
Rob Hagedoorn, Finance
David Platt, Finance

COUNCIL DECISION POINTS & COMMITTEE RECOMMENDATION

The Council will review the Executive's proposed changes to the Charter Limit calculation.

DESCRIPTION/ISSUE

The Executive has proposed an alternative interpretation for calculating the Charter Limit in §305 of the County Charter. The alternative interpretation increases property tax rates by 0.25 cents per $100 and levy an additional $5,170,582 compared to the prior Charter Limit calculation. The Charter gives the Council final authority to set the tax revenues to levy.

SUMMARY OF KEY DISCUSSION POINTS

- See staff report.

This report contains:

Staff report #1-5

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<u>Worksession</u>

M E M O R A N D U M

May 7, 2020

TO: County Council

FROM: Gene Smith, Legislative Analyst
Bob Drummer, Senior Legislative Attorney

SUBJECT: Setting real property tax revenues – Charter Limit calculation

PURPOSE: Review and take a straw vote

The Council supported setting real property tax revenues at the Charter Limit during the May 7, 2020 worksession. Today, the Council will review the Executive's proposed changes to the Charter Limit calculation and take a straw vote on the actual revenues it intends to set in the FY21 budget.

I. Background

A. <u>Section 305 of the County Charter</u>

Below is a copy of the relevant portion from §305 of the County Charter and highlights for today's discussion.

By June 30 each year, the Council shall make tax levies deemed necessary to finance the budgets. Unless approved by an affirmative vote of all current Councilmembers, the Council shall not levy an ad valorem tax on real property to finance the budgets that will produce total revenue that exceeds the total revenue produced by the tax on real property in the preceding fiscal year plus a percentage of the previous year's real property tax revenues that equals any increase in the Consumer Price Index as computed under this section. This limit does not apply to revenue from: (1) newly constructed property, (2) newly rezoned property, (3) property that, because of a change in state law, is assessed differently than it was assessed in the previous tax year, (4) property that has undergone a change in use, and (5) any development district tax used to fund capital improvement projects.

1. **The Council sets the tax levies**. Each March, the Executive recommends that amount of tax levies necessary to fund the recommended budget; however, the Council is the final authority in setting those levies. The Council makes this determination through its budget process and reviewing relevant information before it determines the appropriate levies for the coming fiscal year. The Council exercises its authority in two actions – 1) setting the real property tax rates

when it passes the budget; and 2) approving the revenue schedule in July following the budget decisions.

2. **The setting of real property tax revenues has certain restrictions**. Section 305 of the County Charter describes a calculation that the Council must follow when considering the levies for real property tax revenues. That calculation, simply stated, allows real property tax revenues to only increase by the rate of growth in the Consumer Price Index (CPI) year-to-year. If the Council deems it necessary to levy real property tax rates that exceed this rate of growth, it requires nine affirmative votes.

3. **The restrictions exclude certain properties**. Section 305 of the County Charter allows the Council to exclude certain properties from the calculation referenced in point #2. The limitation placed on the Council in this section of the County Charter was intended to restrict growth of real property taxes on existing property owners in the County.

   Residents chose to exclude properties that changed due to the property use or new construction during the year. This recognized that those property owners were capitalizing on a new economic activity, and the County should be allowed to capture the new taxes generated from this new economic activity. After the initial year of paying taxes based on this exclusion, these properties are then included in the Charter Limit calculation for future years.

4. **The term "Charter Limit" is the colloquial reference to the above calculation in point #2**. The amount of revenues derived from the calculation establishes the threshold question every year for the Council because exceeding that amount triggers a voting requirement. The Council always sets real property tax levies at the Charter Limit to avoid limitations in future growth. Since this is the practice, the term "Charter Limit" has become common parlance to denote the maximum levies on real property tax revenue that the Council may set before nine affirmative votes is required.

B. Breaking Down the Charter Limit Calculation

The Department of Finance (Finance) calculates the Charter Limit for the County each year. To calculate the Charter Limit for the next fiscal year, Finance requires the following information:

- Estimated amount of real property tax revenues collected in the current fiscal year; and
- Percentage growth of the CPI from the previous calendar year.[1]

Those two components are all that is required. Once Finance determines the Charter Limit, it can calculate the numerous real property tax rates and personal property tax rates. These tax rates are then applied to the current assessable base and the estimated new construction assessable base in the next fiscal year to finalize the estimated property tax revenues in the recommended budget.

[1] The specific computation is the twelve months preceding December first of each year. For example, FY21's Charter Limit calculation uses the CPI growth from December 1, 2018 through November 30, 2019. Given the one-month variance, Council staff simplified this calculation to the previous calendar year.

C. Taxes Collected from New Construction

There are five exclusions in §305 of the County Charter, but newly constructed property contributes most of the new taxes generated by these exclusions. Most years, newly constructed properties are the only taxes added to the County's tax revenues. Finance relies on the State Department of Assessments and Taxation (SDAT) to identify which properties are newly constructed.[2]

SDAT issues quarterly bills for new construction. For example, a newly constructed property that is assessed in the first quarter of the tax year pays three quarters of the taxes for that tax year. This is done because newly constructed properties become operational throughout the year. **It is unequitable to require a full year of taxes for a property that was only productive for part of the year**. The result of these quarterly bills generated by SDAT is that most newly constructed properties add only a portion of the total taxes that the property would generate in a complete year. Below is an illustrative table about how these quarterly billing statements would impact a new commercial property valued at $70,000,000 and the amount of real property taxes collected by the County.

Table 1: Illustrative Example of Actual Taxes Paid based on Quarterly Billing Cycle

Quarterly Bill	Assessed Value	Taxes at Full Value	Actual Taxes Paid
¾ Annual Bill	$70,000,000	$685,020	$513,765
½ Annual Bill	$70,000,000	$685,020	$342,510
¼ Annual Bill	$70,000,000	$685,020	$171,255
Annual Bill	$70,000,000	$685,020	$685,020

The FY20 weighted average real property tax rate of $0.9786 per $100 was used.

II. Executive's Proposed Interpretation to Charter Limit Calculation

The estimated amount of real property tax revenues collected in the current fiscal year includes all properties that paid taxes on the tax rolls that fiscal year, including any tax revenues collected from newly constructed properties that were added. For the last 30 years, Finance's application of the calculation in §305 of the County Charter only included actual tax revenues generated by the newly constructed properties.

The Executive's recommended FY21 Operating Budget changed this computation by interpreting the Charter differently. The proposed change would estimate the full value of the amount of tax revenues that the County would have collected if newly constructed properties paid taxes for the full year. This proposed change adds value to the estimated real property taxes paid in FY20 before applying the growth in the CPI. Below are two tables comparing how the Executive's interpretation compares to the prior calculation method. The tax rates are based on the Council-supported $692 Income Tax Offset Credit.

[2] There is much that the Council could discuss about the SDAT process and newly constructed properties. For example, there is a challenge where SDAT inconsistently applies "new construction" to major renovations of existing properties in the County. These issues are important discussions about how the County fully captures certain economic activity but are not pertinent to the discussion the Council is focused on today.

Table 2: Comparing the FY21 Impact from the Prior Calculation Method to the Executive Recommended Calculation Method

	Weighted Average Rate	Revenues
Prior FY Charter Limit Calculation	$0.9785 per $100	$1,830,767,118
CE Rec. FY21 Charter Limit Calculation	$0.9810 per $100	$1,835,937,700
Difference	**0.25 cents per $100**	**$5,170,582**

Table 3: Comparing the FY20 to FY21 Impact from the Prior Calculation Method to the Executive Recommended Calculation Method

	Prior FY Charter Limit Calculation	CE Rec. FY21 Charter Limit Calculation
FY20 Rate	$0.9786 per $100	$0.9786 per $100
FY21 Rate	$0.9785 per $100	$0.9810 per $100
Difference	**(0.01) cents per $100**	**0.24 cents per $100**

How does the Executive's interpretation impact newly constructed properties?

The Executive's proposed interpretation has no impact on newly constructed properties. These properties will continue to pay quarterly property tax bills, like before, and will be included in the tax rolls for the following year.

How does the Executive's interpretation impact existing rate payers in the County?

The Executive's proposed interpretation would modestly increase the tax rate for all existing rate payers in the County for FY21 and every fiscal year after. As illustrated in Table 3, rate payers will see a 0.24 cent per $100 increase on the FY21 bill by applying the Executive's interpretation. **At the median sales price of $450,000, a household's property tax bill will increase by $11.25 based on the Executive's interpretation**.

For additional comparisons, the proposed rate increase is equal to about 7.5% of the Executive's proposed 3.18 cent supplementary school tax increase in the recommended FY21 Operating Budget. Similarly, the proposed rate increase would have occurred if the percentage growth in the CPI had been 1.57%, instead of 1.27% in the previous calendar year.

Is the Charter Limit calculation immutable?

The calculation described in §305 of the County Charter is straightforward as illustrated previously in this memorandum. All Finance needs are two variables – the estimated real property taxes collected in the previous fiscal year and the percentage growth in the CPI from the previous calendar year. Similarly, the County Charter is clear on what properties are excluded from this calculation each year, such as newly constructed property.

There is some ambiguity on how to calculate the revenue received from newly constructed property. County residents clearly intended to exclude newly constructed property taxes from the Charter Limit. This reasoning suggests that it would be acceptable for the County to capture 100% of potential tax revenues generated from these properties. However, it is also reasonable to conclude that this exemption from the Charter Limit includes only those property taxes collected by the County during the year, which is inevitably determined by the time of year the property comes online.

The County chose to interpret the Charter for the past 30 years by including only the taxes received during the year rather than 100% of the potential tax revenue that would be generated in future years. The Executive's methodology for FY21 would alter this interpretation.

Is the Council exceeding the Charter Limit if it sets a tax rate at the Executive's proposed rate?

This depends on whether the Council believes that the Executive's interpretation is a valid application of the Charter or not. The Council has the authority to exceed the Charter Limit by an affirmative vote of all current Councilmembers. If the Council decides to use the Executive's proposed methodology but concludes that this methodology is not the appropriate interpretation of this Charter provision, Council staff recommends that the Council affirmatively indicate its intent to exceed the Charter Limit with an affirmative vote of all current Councilmembers.

What is the Council's decision today?

The Council must indicate whether it will set tax rates using the Executive's proposed methodology or using the previous methodology. A choice to use the previous methodology would result in $5,170,582 fewer resources for the FY21 Operating Budget. The Charter gives the Council final authority to set the revenues to levy.