

Property Tax Developments, 2017-2018

by Catherine Collins, Daphne A. Kenyon, Andrew Reschovsky, Bethany Paquin, and Lars Arnesen



Catherine Collins



Daphne A. Kenyon



Andrew Reschovsky



Bethany Paquin



Lars Arnesen

Catherine Collins is a senior research associate and associate director of the George Washington Institute of Public Policy. She oversees the institute's joint program, Significant Features of the Property Tax, with the Lincoln Institute of Land Policy, and has written on several property tax issues. Daphne A. Kenyon is an economist who serves as a resident fellow in tax policy at the Lincoln Institute of Land Policy and serves as co-director of the institute's State-by-State Property Tax at a Glance data toolkit. Andrew Reschovsky is Professor Emeritus of Public Affairs and Applied Economics at La Follette School of Public Affairs, University of Wisconsin-Madison, and a research fellow at the Lincoln Institute of Land Policy. Bethany Paquin is a research analyst at the Lincoln Institute of Land Policy and co-director of State-by-State Property Tax at a Glance. Lars Arnesen is a property tax research assistant at the George Washington Institute of Public Policy.

In this article, the authors identify and examine six noteworthy property tax trends in 2017-2018.

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U.S. jurisdictions rely heavily on the property tax. In 2015 the tax raised \$488 billion, accounting for 31 percent of state-local taxes and 72 percent of local taxes.¹ State property tax systems vary greatly, which makes a review of trends challenging. However, the critical link between the property tax and school finance and the fact that the property tax is an important component of tax incentive packages, among other things, makes it important for those seeking to understand state and local tax policy.

¹Urban Institute and Brookings Institution Tax Policy Center, State and Local Government Finance Data Query System (undated).

This paper divides property tax developments in 2017 and 2018 into six areas: the impact of federal tax reform, property tax incentives in the Amazon and Foxconn megadeals, tax increment finance, school finance, nonprofits, and dark stores.

The Tax Cuts and Jobs Act of 2017

The major overhaul of the federal tax code embodied in the Tax Cuts and Jobs Act (P.L. 115-97) is likely to reduce support for property taxation, especially in high-tax states. Before passage of the TCJA, about one-half of homeowners benefited from the property tax

deduction.² Simulations by the Urban-Brookings Tax Policy Center suggest that in 2018 the number of itemizers will decline by nearly 60 percent.³ This drop is a result of the near doubling of the standard deduction and restrictions placed on several itemized deductions. Most noteworthy is the \$10,000 cap on total state and local income, sales, and property tax deductions.

From its beginning, the federal income tax allowed for a SALT deduction. Deductibility subsidizes SALT payment by reducing the cost to taxpayers of paying additional taxes. If the property tax is fully deductible, a \$100 increase in property taxes costs a taxpayer who faces a 25 percent federal marginal tax rate only \$75. Expressed as a fraction, the taxpayer's tax price is 0.75.⁴ Losing the ability to deduct the \$100 property tax payment raises the tax price to 1 — a 33 percent increase.⁵

Taxpayers with higher incomes, and hence higher marginal tax rates, will generally face the largest tax price increases. While taxpayers in all states will be subject to increasing SALT prices, primarily because fewer taxpayers will itemize deductions, the largest tax price increases will be concentrated in high-tax states, where a larger share of taxpayers will be affected by the \$10,000 SALT deduction cap. In 2015 the average SALT deduction exceeded \$10,000 in 19 states and the District of Columbia.⁶ In Connecticut, a high-tax state, the average

taxpayer will face a SALT price increase of between 8 and 21 percent because of the TCJA.⁷

It is difficult to predict how taxpayers will respond to the rising cost of SALT. Both economic theory and common sense suggest that as prices rise, willingness to pay will decline. There is evidence that rising tax prices will reduce taxpayer support for state and local taxes and the spending financed by these taxes.⁸ At the local level, there may be rising opposition to property tax increases, especially from high-income taxpayers who reaped the largest tax benefits from the SALT deduction. Taxpayer support for local referenda to override property tax limitations, such as Massachusetts's Proposition 2 1/2, is also likely to suffer.⁹ Funding of public education is particularly at risk. Not only does the property tax play a major role in funding education, but reduced political support for state government income and sales taxation will likely result in reduced state aid to local school districts.

Supporters of the SALT deduction cap argue that not only does it raise a substantial amount of federal income tax revenue (almost \$650 billion over 10 years according to an estimate by the Tax Policy Center) but limiting SALT deductions will increase the progressivity of the federal income tax. Those opposed to restricting the SALT deduction assert that the SALT deduction cap will have different impacts in different states, with the share of taxpayers subject to the cap much larger in high-tax and high-spending states. The largest share of state and local spending goes to education and healthcare. By encouraging higher spending, the SALT deduction supports a better educated and healthier population. Further, evidence suggests that states with higher rates of itemization tend to

² According to the 2016 five-year American Community Survey, there were 74.9 million owner-occupied housing units in the United States. About one-half (37.6 million) took a property tax deduction in 2015.

³ Urban-Brookings Tax Policy Center, Model Estimates, "Table T18-0001 — Impact on the Number of Itemizers of H.R. 1, The Tax Cuts and Jobs Act (TCJA), By Expanded Cash Income Level, 2018," Jan. 11, 2018.

⁴ For this taxpayer, a \$100 increase in property taxes increases the SALT deduction by \$100 and lowers federal taxable income by the same amount. Given a 25 percent federal marginal tax rate, federal income taxes decrease by \$25. So, the net cost of paying the extra \$100 in property taxes is \$75 (\$100 - \$25). Expressed as a fraction, the tax price is 0.75.

⁵ Calculated as $(1-0.75)/0.75$.

⁶ Phillip Oliff and Brakeyshia Samms, "Cap on the State and Local Tax Deduction Likely to Affect States Beyond New York and California," Pew Charitable Trusts (Apr. 10, 2018).

⁷ Andrew Reschovsky, "The SALT Deduction Cap: What Will It Mean for New England States?" Lincoln Institute of Land Policy (May 11, 2018). The average percentage increase in tax price includes a substantial number of taxpayers whose tax price remains unchanged (at 1.0) under the TCJA. These taxpayers were either non-itemizers or were subject to the AMT and thus did not benefit from the SALT deduction.

⁸ Martin S. Feldstein and Gilbert E. Metcalf, "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," *J. of Pol. Econ.*, 710 (Aug. 1987); and Howard Chernick and Andrew Reschovsky, "Federal Tax Reform and the Financing of State and Local Governments," *J. of Pol'y Analysis & Mgmt.* 863 (1986).

⁹ It is unclear how long it will take for taxpayers to respond to rising tax prices. The responses may be felt most strongly during the next recession, when falling SALT revenues place more pressure on local governments to raise tax rates.

have more progressive state tax systems.¹⁰ The decline in the top federal marginal tax rates under the TCJA, along with the economic windfalls that high-income households receive because of large corporate income tax cuts, will increase after-tax income inequality in the United States. Capping SALT deductions may reduce progressive elements of state and local fiscal systems, further contributing to rising income inequality.

Because property tax payments made during 2018 will be subject to the SALT deduction cap, some taxpayers sought to pay their 2018 taxes at the end of 2017. Although the IRS warned taxpayers that not all prepayments of 2018 property taxes would be allowed, it appears that the prepayment of already issued 2018 property tax bills will pass muster.¹¹ Although it remains unclear how many property owners would be able to legally prepay their property taxes, fourth quarter 2017 property tax collections were more than 9 percent higher than in the same quarter in 2016.¹²

In recent months, New York, Connecticut, and New Jersey have enacted legislation that allows local governments to circumvent the SALT deduction cap. These laws authorize local governments to create entities or funds that can accept charitable donations in support of education and other local government functions. Taxpayers making these fully tax-deductible contributions will receive a property tax credit that offsets most of their contribution.¹³ Several other states are considering similar legislation.

On August 23, the IRS proposed rules that would block the charitable deduction workaround by largely disallowing the deduction of charitable contributions for which an offsetting tax credit is received. The issue is far from settled, with legal scholars holding diverse views. Daniel Hemel, a

professor at the University of Chicago Law School, has argued that the legality of issuing tax credits for charitable contributions rests on two premises regarding federal tax law that are “robustly supported by administrative and judicial precedent.”¹⁴ Jared Walczak, a senior policy analyst at the Tax Foundation, calls proposed workarounds inventive and interesting but “unlikely to succeed.”¹⁵ In July the states of Connecticut, Maryland, New Jersey, and New York filed a suit in U.S. District Court claiming that the imposition of the SALT deduction cap is unconstitutional. The outcome of that suit awaits a decision by the court.

Tiffs over TIFs

Tax increment financing (TIF) is an economic development tool used in 49 states and the District of Columbia. TIF uses the “increased property tax revenues generated by new development or real estate appreciation to fund economic development activities in the area that generated the revenues.”¹⁶ Although there is no definitive tabulation of TIF districts, it appears that states are using them more often. For example, over the last decade, the number of TIF districts in Iowa has grown from 949 to 3,340.¹⁷

Despite the popularity of TIF as an economic development tool, public policy analysts have concerns about it. One that applies to property tax incentives for business generally, as well as to TIFs specifically, is that proliferation tends to decrease effectiveness. As Daphne A. Kenyon, Adam H. Langley, and Bethany P. Paquin state: “There will always be political pressure for broadening of the criteria for eligibility for property tax incentives, but it is important for state policymakers to resist this pressure. If they do not, the effectiveness of such incentives declines, and the only result is that

¹⁰ Chernick, “On the Determinants of Sub-National Tax Progressivity in the U.S.,” *Nat'l Tax J.* 93 (Mar. 2005).

¹¹ Laura Saunders, “The Hot Debate: Can You Deduct Prepaid Property Taxes?” *The Wall Street Journal*, Apr. 3, 2018.

¹² Lucy Dadayan, “Robust State and Local Revenue Growth in the Fourth Quarter of 2017; Federal Tax Cuts Cloud Horizon,” Rockefeller Institute of Government (May 2018).

¹³ In New York, local governments can provide taxpayers with property tax credits of up to 95 percent of their contributions to local charitable funds. In New Jersey, the ceiling on property tax credits has been set at 90 percent of the value of contributions, but in Connecticut, local governments are authorized to give a property tax credit equal to the value of the entire charitable contribution.

¹⁴ Daniel Hemel, “The Death and Life of the State and Local Tax Deduction,” Mar. 13, 2018.

¹⁵ Jared Walczak, “State Strategies to Preserve SALT Deductions for High-Income Taxpayers: Will They Work?” *State Tax Notes*, Feb. 12, 2018, p. 635.

¹⁶ David Merriman, “Improving Tax Increment Financing (TIF) for Economic Development,” Lincoln Institute of Land Policy, Policy Focus Report (forthcoming Sept. 2018).

¹⁷ Merriman, Di Qiao, and Tianshu Zhao, “Evidence about State by State Use of Tax Increment Financing,” SSRN, Mar. 20, 2018.

local government revenues have been reduced.”¹⁸ A second concern is the impact on overlapping jurisdictions, such as school districts. As Joan Youngman states: “The municipality establishing the TIF district may be able to appropriate value increases, including those due only to inflation, from independent districts with no power to block this transfer.”¹⁹ To the extent TIF districts capture property tax revenue from school districts, they can have an unintended negative impact on school expenditures. A recent study of TIF in Iowa found that greater use of TIF is associated with reduced education spending.²⁰

Since 2017 nine states have passed substantive legislation to change TIF (see Table).²¹ In some cases, the legislation appears intended to reform TIF; in other cases, it reflects an expansion. In 2017 North Dakota, Colorado, and Montana amended their statutes that authorize the use of TIF to address the issue of a TIF district preempting local taxing authorities’ revenues.²² These states have addressed the issue by either allowing the school districts to opt out of the district (thereby allowing the school district to capture the increased value attributable to development in the TIF area) or by requiring consultations with the affected taxing authorities, so at least there is an understanding on the part of both the TIF district and the local jurisdictions.

Kansas similarly enacted legislation to protect some school districts. Beginning July 1, 2017, redevelopment districts can no longer include the levy for education capital while the bioscience development districts cannot include the general education levy and the education capital levy. The incremental value in these TIF districts for these levies is now available to school districts.²³ Other

TIF districts, including those for neighborhood revitalization, continue to have access to both general educational and capital levies.

To increase the period of its bond financing, Kentucky extended the life of the Louisville Arena TIF from 20 to 45 years.²⁴ Financial complications have plagued the project, including over-optimistic finance projections and slower investment in the district, resulting in inadequate property value growth. The district was created in 2006 as a state pilot district, accessing 80 percent of the state property and sales taxes in the district. In addition to state pilot TIFs, Kentucky TIFs can be totally local, or in some circumstances, the local TIF can be a state TIF, allowing access to state revenues. Legislation was needed in 2017 for a local development group to create a mixed-use TIF, the WKT Technology Park, on the site of a defunct college that included undeveloped land.²⁵ While local TIFs are generally established on undeveloped land, local programs may be eligible for state participation if requirements are met. The 2017 legislation allows for the WKT Park to be considered for state participation and therefore access of up to 80 percent of incremental state taxes.²⁶

Vermont TIF districts are unique because local TIFs can include the state education property tax. As state funds are involved, the state limited the number of TIFs and allowed up to 75 percent of the state revenues to be used. The local allocation was required to be at least 80 percent of the local increment. Legislation in 2017 decreased the state amount to 70 percent, thus reducing the financial pressure on the state while requiring a larger local contribution.²⁷ The legislation provided for the creation of seven new districts, in addition to the 10 active districts, and empowers the Vermont Economic Progress Council to authorize new TIF districts, rather than requiring legislative approval. The legislation also authorized municipalities to create solely local TIF districts, without state approval, using only local taxes.

¹⁸ Kenyon, Langley, and Paquin, “Property Tax Incentive Pitfalls,” *Nat’l Tax J.* 1011 (Dec. 2012).

¹⁹ Youngman, “A Good Tax: Legal and Policy Issues for the Property Tax in the United States,” Lincoln Institute of Land Policy (2016).

²⁰ Phuong Nguyen-Hoang, “Tax Increment Financing and Education Expenditures: The Case of Iowa,” *Educ. Fin. and Pol’y* 515 (Fall 2014).

²¹ To generate a table of TIF statutes by state, visit Significant Features of the Property Tax. Lincoln Institute of Land Policy and George Washington Institute of Public Policy.

²² 2017 N.D. Session Laws, chs. 14, 277; 2017 Colo. Session Laws, ch. 249, section 1, subsection. 9.6; 2017 Mont. Session Laws, ch. 157.

²³ 2017 Kan. Acts, ch. 95, section 5.

²⁴ 2017 Ky. Public Act 189.

²⁵ 2017 Ky. Public Act 174.

²⁶ Mixed-use TIFs may access the state property tax, individual income taxes, withholding tax, corporate income tax, limited liability entity tax, and sales tax.

²⁷ 2017 Vt. Public Act No. 69, section J.

Minnesota and Wisconsin expanded the types of activities that can use TIF. Minnesota's new workforce housing districts can provide market-rate rental housing if both the municipality and school district agree to the project.²⁸ The creation of this type of district was in response to a growing shortage of affordable housing.²⁹ Wisconsin created a special electronics and information technology manufacturing (EITM) zone in which a TIF district can be established. Such a district is not limited in size or to the type of eligible public infrastructure. These changes made it possible for increased local contribution to complement the state's economic incentive package for Foxconn.³⁰

Delaware expanded the use of TIFs beyond New Castle County by authorizing the City of Dover and Kent County to create TIFs.³¹ Although not restricted to a specific project, the county anticipates using a TIF district for the expansion of the Dover Mall. As part of the project, the state anticipates building an access toll road to the mall with the tolls sufficient to support the state bonds. If needed, the county's TIF incremental funds will also support the debt. The local increment may also be used for either the mall or debt service if the city and other local jurisdictions so choose.

A 2018 Wisconsin Supreme Court ruling upheld the use of TIF revenue to provide cash grants to developers for project costs, a common practice that Solicitor General Misha Tseytlin warned, if overturned, would "imperil numerous projects critical to Wisconsin's economic growth, including the Village of Mount Pleasant's recent agreement with Foxconn Technology Group." In *Voters with Facts v. City of Eau Claire*,³² a group of taxpayers represented by the Wisconsin Institute for Law and Liberty argued that cash grants constituted a property tax rebate in violation of the state's uniformity clause and that the Eau Claire TIF districts created to help fund the Confluence Art Center were not blighted areas. The court ruled that the city had not violated the constitution or statutory requirements but granted the plaintiff's

request for a lower court to review claims regarding blight and "but for" criteria.

Depending on the lower court's decision, the ruling could have significant ramifications for TIF projects across the state. If it is determined that the district was not blighted, it raises fundamental questions regarding the use of public funds for private purposes. Because many state constitutions require that public revenue be used only for public purposes, the remediation of blighted areas is considered one of the justifications for the creation of TIF districts. However, while defining blight is relatively straightforward, quantifying it is significantly more difficult because it introduces an element of subjectivity. The lower court's review will turn on whether the municipality correctly identified the area as blighted.

Amazon and Foxconn Megadeals

Amazon

The long-term economic impact of tax incentive packages has long been questioned.³³ Nevertheless, state and local governments continue to vie for businesses by putting together incentive packages — packages that include both public investment to attract business and tax breaks to lower a company's operating costs. For local governments, these incentive packages generally mean additional pressure on their primary tax — the property tax. Nowhere is this competition more visible than in Amazon's selection of a new headquarters, dubbed HQ2, which received sales pitches from 238 state and local governments.

Although no stranger to procuring local tax breaks,³⁴ Amazon took a different approach in finding a location for HQ2, a proposed \$5 billion facility, with its estimated 50,000 jobs. Unlike most negotiations in which a company identifies a small number of locations and then negotiates with each

²⁸ 2017 Minn. First Special Session, ch. 1, art. 6.

²⁹ League of Minnesota Cities, "Focus on New Laws: New Workforce Housing Tools" (Sept 25, 2017).

³⁰ 2017 Wis. Act 58.

³¹ 2017 Del. Laws chs. 22-26.

³² 913 N.W.2d 131 (Wis. 2018).

³³ There have been volumes written on the effectiveness of tax incentives. The consensus is that they are, at best, marginally effective within an area. See Kenyon et al., "Rethinking Property Tax Incentives for Business," Policy Focus Report, Lincoln Institute of Land Policy (June 2012).

³⁴ Thomas Cafcas and Greg LeRoy, "Will Amazon Fool Us Twice? Why State and Local Governments Should Stop Subsidizing the Online Giant's Growth Distribution Network," Good Jobs First (Dec. 2016).

to extract the best deal, Amazon opened the process to general competition.

While the prospect of landing the big deal generated intense public interest, the process generally has not been transparent, with little community involvement and few specifics of the incentives offered. Yet in October 2017, the 238 proposals from across North America extolled each applicant's diversity, stable business environment, good public transportation, educated labor force, and affordable housing — all key Amazon criteria.³⁵ In January, the company announced a short list of 20 locations.

Since Amazon is asking for tax consideration, some public interest groups are concerned that the process will lead to a race to the bottom, since historically states have provided expensive tax breaks to attract megadeals. Yet it is unclear that the biggest tax incentive package will be the deciding factor.

Unlike many other places, Columbus, Ohio — one of the 20 second-round locations — made the city's initial proposal public. The city recognized that it needed to balance the tax incentives with providing public services. Nonetheless, the city proposed property tax and local income tax incentives. While both incentives are scheduled for 15 years, the annual income tax incentive — structured as a payment to Amazon of a percent of the income taxes withheld from payroll — is capped at \$50 million annually, up to \$400 million. On the other hand, property tax relief is open-ended. The city's proposal calculates that each \$1 million of investment generates a tax savings (cost) of \$30,450 in city and school property taxes. Assuming the full \$5 billion investment, Amazon's annual tax savings could top as much as \$152 million. Other costs to the city included in the package are funding for the purchase and site preparations of the land and transportation investment.³⁶ While the local package is known, the state component provided by the state's privatized economic development agency, JobsOhio, has not been made public.

Incentives offered by some states have come to light because they have adopted legislation either specifically for their Amazon proposal or have tweaked their existing incentive programs. North Carolina, while bidding for the Foxconn facility, expanded its Job Development Incentive Grant for a "transformative project" that includes an investment of \$4 billion and 5,000 employees.³⁷ The legislation increased the size and the time period of the grant.³⁸ Although not definitive, it may be assumed that since the state was unsuccessful in attracting the Foxconn and Toyota-Mazda megadeals, the Research Triangle bid would incorporate the state incentives for a transformative project.

A few states have enacted new legislation that appears to be part of their Amazon bid. Maryland enacted legislation available for "certain *Fortune* 100 companies." The title — the "Promoting Extraordinary Innovation in Maryland's Economy (PRIME) Act" — makes it evident that the legislation targets Amazon.³⁹ In addition to corporate tax incentives, the legislation provides a credit of 50 percent of the property taxes attributed to the increase in the assessed value for 10 years, with the state reimbursing the local government for half of the local credit. The bundle is estimated to provide \$8.5 billion of incentives.

New Jersey also enacted state tax relief called the "Transformative Headquarters Economic Assistance Program." The package provides \$100,000 per job and is estimated to provide up to \$5 billion in total incentives.⁴⁰ Newark, the state's second-round location, passed additional payroll tax incentives. Another bill under consideration would expand the city's long-term property tax exemption to include "transformative headquarters."

Although there are few details as to the total packages offered to Amazon, there has been pushback, with some observers wondering if the winning location could actually be a loser. Given

³⁷ Lauren K. Ohnesorge, "Commerce Secretary: N.C. Offered 'Monumental' Incentive for Amazon HQ2," *Triangle Business Journal*, Oct. 24, 2017.

³⁸ 2017 N.C. Session Laws 57.

³⁹ 2017 Md. Laws ch. 350. The state portion of the property tax is also abated.

⁴⁰ N.J. Public Laws 2017 ch. 282.

³⁵ Amazon.com, Amazon HQ2 RFP.

³⁶ Rick Rouan, "Documents Detail Columbus' Bid to Lure Amazon's 2nd HQ," *The Columbus Dispatch*, Oct. 19, 2017.

the extensive tax breaks offered, there is concern that tax base erosion could jeopardize public services and infrastructure. Other concerns have been raised concerning the potential impact such a large influx of people will have on the local housing market.⁴¹ As has been pointed out often, and especially in response to the HQ2 competition, communities and states might be better served if they do not win.⁴²

What does HQ2 say about the future of tax incentives? An interesting aspect of this competition is not how much tax revenue states and local governments are willing to forgo, but rather the extent to which it provides a roadmap to what is needed for economic development to flourish in the 21st century. Being a business-friendly area may not just mean huge tax breaks — recent media reports discuss the importance of social issues.⁴³ The answer will depend on what the winning package provides. If it includes more of the enduring aspects such as specialized training, increased STEM education programs, 21st century infrastructure, and adequate housing, governments may get the message as to where their tax dollars should go — public services, not tax abatements. But that is, of course, if the winning bid does not provide large, long-term tax incentives.

Foxconn

In the summer of 2017, Wisconsin Gov. Scott Walker (R) announced that the state had reached an understanding with Foxconn to build its first U.S. plant in Wisconsin, bringing 13,000 jobs and \$10 billion in capital investment. The next day, Walker called a special legislative session to enact the \$3 billion incentive package.⁴⁴ In addition to the

state incentives, the legislation created an EITM zone, incorporating TIF for the local government.⁴⁵ The legislation reduced several TIF restrictions, allowing the Village of Mount Pleasant to create a TIF that covers almost 20 percent of the village and to provide additional incentives. These include direct support to the company and using TIF funds to support police and fire services and improve Racine County infrastructure to ease the burden on residents. The local package totals \$785 million.

Because of the size of the Foxconn district, about \$1.7 million in property tax revenues had been generated for the school district, village, county, and technical college. According to the agreement between the village and Foxconn, the project is expected to add \$1.4 billion in value by 2022, which is anticipated to generate \$31 million annually for the TIF district. The village, through its community development authority, plans to issue \$140 million in TIF bonds, supported by the incremental tax revenue. While construction is targeted to be completed by 2023, the bonds are expected to be in place until 2049.⁴⁶ Foxconn will cover any shortfall should the incremental value fall below \$1.4 billion.⁴⁷ This support benefits the TIF bond payment, but the school district and other taxing jurisdiction will not benefit from the investment while the bonds are outstanding — some 40 years, compared to the 15 years for the state incentive package of refundable tax credits.⁴⁸ As with this package, local governments often bear a significant burden while the overall economic growth is more widespread, throughout the region and state.

⁴¹ Sydney Bennet, "Prime Markup: How Much Would Amazon HQ2 Drive Up Rents?" Apartment List, Oct. 19, 2017.

⁴² Angela Glover Blackwell, "Cities Should Invest in Their Future Rather Than Compete to Give Away the Store," Penn Institute for Urban Research, Jan. 18, 2018.

⁴³ Jonathan O'Connell, "The Unspoken Factor in Amazon's Search for a New Home: Jeff Bezos's Support for Gay Rights," *The Washington Post*, Apr. 20, 2018.

⁴⁴ Like the Tesla agreement, the Foxconn package is 50 times larger than any other incentive given by the state. See Billy Hamilton, "Buffalo Hunting' in Wisconsin," *State Tax Notes*, Aug. 21, 2017, p. 793.

⁴⁵ In addition to creating the EITM zone, the legislation waived multiple wetlands regulations for the Foxconn factory construction. The company is permitted to discharge dredged materials, fill wetlands, change the course of streams, build artificial bodies of water that connect with natural waterways, and build on a riverbed or lakebed. Foxconn is also exempt from having to create a state environmental impact statement as required for smaller projects. 2017 Wis. Act 58 Aug. Special Session A.B. 1.

⁴⁶ Yvette Shields, "Wisconsin Foxconn Plant Offers Opportunity for Bond Underwriters," *The Bond Buyer*, Feb. 22, 2018.

⁴⁷ "Project Plan for the Creation of Tax Increment District No. 5," Village of Mount Pleasant, Wisconsin, Oct. 4, 2017.

⁴⁸ Wisconsin Legislative Fiscal Bureau, memo to members of Wisconsin Legislature, "August 2017 Special Session Assembly Bill 1: Foxconn/Fiserv Legislation," Aug. 8, 2017.

Keeping the Books Open on School Funding

Historically, the property tax has been closely linked to education. In 2014-2015 local governments provided 45 percent of the funding for elementary and secondary schools, and more than 80 percent of that local funding came from the property tax.⁴⁹ Although the property tax has provided a stable funding source for schools, inequities among school districts have been the subject of legal challenges across the United States since the 1960s and have led to massive restructuring of many states' property tax systems.⁵⁰ Since 2017 state high court school finance rulings have been issued in five states.

Two recent rulings favored the challengers to state education funding practices. In June 2018, for the sixth time in eight years, and after the Legislature significantly increased school funding, the Kansas Supreme Court ruled that the state's system for funding education is still constitutionally inadequate. The court ordered the state to increase state aid before the end of June 2019.⁵¹ In September 2017, in *William Penn School District v. Pennsylvania Department of Education*,⁵² the Pennsylvania Supreme Court reinstated a lawsuit challenging the state's system of school funding. That lawsuit "contends that Pennsylvania's school-funding system violates the state constitution's guarantee of a 'thorough and efficient system' of education as well as its equal-protection provision."⁵³ The case was remanded to the trial court to determine several issues, including what the constitution's "thorough and efficient clause" means.⁵⁴

Three recent court rulings ended challenges to state education funding practices. One is *McCleary v. State*,⁵⁵ a Washington state school funding case that began in 2007.⁵⁶ In 2014 the Washington Supreme Court found the Legislature in contempt for making insufficient progress in meeting the *McCleary* funding requirements, and starting in August 2015, the court levied a daily fine of \$100,000 against the state.⁵⁷ To try to bring the state into compliance, the Legislature increased education funding in both 2017 and 2018, paid for in large part by increasing the statewide property tax.⁵⁸ State funding is projected to be 72 percent higher in 2019 than in 2012.⁵⁹ In response, in June 2018 the Washington Supreme Court ended its jurisdiction in *McCleary*.

In January 2018 a Connecticut Supreme Court ruling ended more than a decade of school finance litigation when it overturned a superior court ruling that the state's school funding denied students their constitutional right to an adequate education. The high court declared "that the state had met its minimal constitutional obligations and beyond that, it is up to the legislature to set educational policy."⁶⁰ The Mississippi Supreme Court ruled in *Clarksdale Municipal School District v. Mississippi*⁶¹ that the state Legislature "is not constitutionally required to fully fund the Mississippi Adequate Education Program."⁶²

In 2018 a school funding lawsuit was filed in Delaware for the first time. Brought by the American Civil Liberties Union of Delaware and the Community Legal Aid Society, *Delawareans for Educational Opportunity v. Carney* charges that the state does not give "all children a meaningful opportunity to obtain an adequate education and a

⁴⁹ Calculations based on data in National Public Education Financial Survey Data, 2014-15.

⁵⁰ Reschovsky, "The Future of U.S. Public School Revenue from the Property Tax," Policy Brief, Lincoln Institute of Land Policy (July 2017). See also Kenyon, "The Property Tax School Funding Dilemma," Lincoln Institute of Land Policy, Policy Focus Report 2007, which provides a history of U.S. school funding lawsuits since the 1960s. In 1973 the U.S. Supreme Court shut the door on federal school funding lawsuits, and since then all constitutional school funding lawsuits have been litigated in state courts.

⁵¹ Dion Lefler et al., "Kansas School Funding Still Inadequate, Supreme Court Says," *The Kansas City Star*, June 25, 2018.

⁵² 170 A.3d 414 (Pa. 2017).

⁵³ Maddie Hanna, Kristen A. Graham, and Kathy Boccella, "Pa. Supreme Court Opens Door to School Funding Overhaul," *The Inquirer Daily News*, Sept. 28, 2017.

⁵⁴ SchoolFunding.Info, "Pennsylvania Plaintiffs File Major New Adequacy and Equity Case," Nov. 21, 2014.

⁵⁵ 269 P.3d 227 (Wash. 2012).

⁵⁶ Joseph O'Sullivan, "Washington Supreme Court Ends Long-Running McCleary Education Case Against the State," *The Seattle Times*, June 7, 2018.

⁵⁷ *McCleary v. State*, 128 *Harv. L. Rev.* 2048 (May 10, 2015).

⁵⁸ Jerry Cornfield, "State Supreme Court to Evaluate State's Education Funding Plan," *HeraldNet*, Sept. 9, 2017.

⁵⁹ \$11.7 billion instead of \$6.8 billion. State of Washington Budget, 2019 Public Schools.

⁶⁰ Matthew Kauffman and Edmund H. Mahony, "Sweeping Education Ruling Overturned by Connecticut Supreme Court," *Tribune News Service*, Jan. 19, 2018.

⁶¹ 2015-CA-01227-SCT (Miss. 2015).

⁶² SchoolFunding.Info, "Mississippi Supreme Court Rejects Constitutional Funding," Nov. 8, 2017.

substantially equal educational opportunity” and “that the state relies too heavily on local taxes to fund schools.”⁶³ Until this suit, Delaware was one of five states that had never had a lawsuit charging that state school funding was constitutionally inadequate.⁶⁴

Vermont has had its own unique property tax-school funding challenges. In recent years, there has been growing concern that Vermont’s school districts are too numerous, too small, and a leading contributor to excessive spending on education and high property tax burdens. In response, over the last decade the Vermont legislature attempted a variety of school consolidation initiatives.⁶⁵ In 2015 the legislature passed Act 46, which gives tax breaks to districts that consolidate but imposes spending caps on districts that refuse to consolidate by 2019.⁶⁶ In June, the education secretary released a proposal for 18 consolidations, which will eventually lead to a final statewide consolidation plan.⁶⁷

Nonprofit Property Tax Exemption

All 50 states exempt charitable nonprofits from paying property taxes. Although criteria vary, most states extend the exemption to nonprofits designated by the federal government as 501(c)(3) organizations.⁶⁸ In recent years, municipal governments, facing fiscal pressure, have increasingly scrutinized these organizations in an effort to safeguard their tax bases.⁶⁹ In 2017 and early 2018, court actions in two states brought notable victories for charities, while in a third state, a court ruling clarified the scope of the nonprofit exemption. Although many legislatures considered measures to curtail the nonprofit

exemption, including linking the exemption to executive salaries and other criteria,⁷⁰ no state enacted major policy changes.

Hospitals are the most frequent target of nonprofit exemption challenges.⁷¹ Litigation in Illinois led to legislation setting out criteria for hospitals to receive a property tax exemption. In *Provena Covenant Medical Center v. Department of Revenue*,⁷² the Illinois Supreme Court ruled the hospital’s level of charity care was insufficient to receive a tax exemption. The General Assembly enacted a law requiring healthcare institutions to provide charity care equal to or greater than the value of their exemption, and litigation on the issue has continued. In a unanimous ruling in March 2017, the Illinois Supreme Court vacated a 2016 appellate court ruling finding the state statute unconstitutional and establishing criteria for tax exemptions for nonprofit hospitals based on charity care. The high court sent the case back to circuit court, concluding that the lower court lacked jurisdiction.⁷³ The Illinois Supreme Court recently heard arguments in a separate case on the nonprofit property tax exemption in which lower courts had ruled in favor of hospitals. In *Constance Oswald v. Illinois Department of Revenue*, the plaintiff challenges the constitutionality of the state’s property tax code that grants nonprofit hospitals a property tax exemption if they provide charity care in excess of the value of their exemption.⁷⁴

In Michigan, Grand Rapids Charter Township vowed to appeal a Michigan Tax Tribunal ruling in favor of Spectrum Health Medical Group that upheld the healthcare company’s tax exemption and required the township to refund property taxes paid on the exempt property.⁷⁵ In 2018 the Kentucky Supreme Court ruled the state’s charitable exemption under section 170 of the state’s

⁶³ SchoolFunding.Info, “Major Adequacy Case Filed in Delaware,” Jan. 23, 2018.

⁶⁴ The other four states are Hawaii, Mississippi, Nevada, and Utah. The Mississippi lawsuit described above did not allege that the state fell short of constitutionally adequate school funding.

⁶⁵ Vermont Legislative Research Shop, “School District Consolidation,” University of Vermont (Mar. 1, 2007).

⁶⁶ Daarel Burnette II, “Consolidation Push Roils Vermont Landscape,” *Education Week*, Feb. 16, 2016.

⁶⁷ Stacey Peters and Colin Meyn, “Act 46 Plan Recommends 18 School District Mergers,” *Vermont Digger*, June 1, 2018.

⁶⁸ Kenyon and Langley, “Payments in Lieu of Taxes: Balancing Municipal and Nonprofit Interests,” Lincoln Institute of Land Policy (Nov. 2010).

⁶⁹ Catherine Collins and Percy Ross, “Property Tax Year in Review 2016,” *State Tax Notes*, June 5, 2017, p.979.

⁷⁰ Conn. H.B. 6468 (2017); Mont. H.B. 331 (2017); and Mass. H.3526 (190th session).

⁷¹ Kenyon and Langley, “Payments in Lieu of Taxes: Balancing Municipal and Nonprofit Interests,” Lincoln Institute of Land Policy (Nov. 2010).

⁷² 925 N.E.2d 1131 (Ill. 2010).

⁷³ *The Carle Foundation v. Cunningham Township*, 2017 IL 120427.

⁷⁴ Franczek Radelet, “Illinois Supreme Court Hears Oral Argument on Hospital Property Tax Exemptions,” *JDSupra.com*, May 23, 2018.

⁷⁵ Mark Sanchez, “Tribunal Rules Grand Rapids Township Must Repay Spectrum Health’s Property Taxes,” *MiBiz.com*, Feb. 17, 2017.

constitution applies solely to property taxes.⁷⁶ In the case brought by Interstate Gas Supply Inc., the plaintiff sought a refund of use taxes paid on behalf of a client recognized as a purely public charity that provided laundry services to nonprofit hospitals. The court rejected the plaintiff's argument that the use tax operated as a property tax and should therefore be subject to exemption. The court ruled that section 170 does not apply to use taxes.⁷⁷

When a property's use changes, local governments may reconsider its tax-exempt status. For example, in 2017 a New Jersey court ruled against the City of Trenton,⁷⁸ finding the Holy Trinity Baptist Church qualified for a charitable exemption because the property was being used for religious purposes, even though the church had moved most of its operations to a new building and intended to sell the subject property.⁷⁹

In 2017 Oregon enacted a law extending the property tax exemption to property of LLCs wholly owned by tax-exempt nonprofits if the nonprofit owner would qualify for an exemption.⁸⁰ The IRS recognizes an LLC owned by a qualifying charity as a tax-exempt entity for federal tax purposes if the LLC meets specific criteria.⁸¹ Some states follow the federal government in recognizing LLCs owned by qualifying nonprofits as exempt, while others allow formation of LLCs for business purposes only or have a separate class of LLCs specifically for nonprofits.

Shedding Light on Dark Stores

The spread of "dark store" assessment appeals by major big-box retailers threatens local property

tax bases in a growing number of states.⁸² Dark store assessment theory asserts that sales of vacant big-box stores, or dark stores, can be the best comparable sales for valuing occupied big-box stores and argues that assessment should reflect the value of the property to a hypothetical buyer rather than the current tenant. Proponents of dark store theory point to a declining big-box retail sector and lower demand for retail space in arguing that stores are over-assessed.⁸³ The theory is one of several arguments that have given rise to big-box property tax assessment appeals in recent years. In 2017 and the first half of 2018, at least five states⁸⁴ grappled with major court rulings on dark stores cases, and four states considered legislation aimed at curbing dark store assessment appeals (see the table).

The wave of big-box property tax appeals has been concentrated in the Midwest, but cases have also cropped up in Alabama, Florida, Kansas, New York, North Carolina, Oregon, Tennessee, Texas, and Washington. When state courts favor plaintiffs, local governments are left grappling with depleted tax bases. Wisconsin alone has seen over 200 dark store lawsuits.⁸⁵ Research by the League of Wisconsin Municipalities, a vocal critic of dark store assessment theory, estimates that if the approach was applied to all commercial assessments, residential property taxes in Wisconsin communities with a high share of retail property could rise between 4 to 17 percent.⁸⁶ Since 2010 communities in Michigan and Indiana have refunded retailers over \$100 million and \$120 million respectively because of successful appeals.⁸⁷

⁷⁶ *Department of Revenue v. Interstate Gas Supply Inc.*, 2016-SC-000281-DG (Ky. 2018).

⁷⁷ "Kentucky Supreme Court Limits Charitable Tax Exemption to Property Taxes Only," Bingham Greenbaum Doll LLP, June 25, 2018.

⁷⁸ *Holy Trinity Baptist Church v. City of Trenton*, No. 015909-2014 (N.J.T.C. 2017).

⁷⁹ Cole Scholtz, "Tax Court Puts Brakes on Recent Trend Limiting Religious/Non-Profit Exemptions," JDsupra.com, Feb. 22, 2017.

⁸⁰ Or. S.B. 149 (2017).

⁸¹ Richard A. McCray and Ward L. Thomas, "Limited Liability Companies as Exempt Organizations — Update" Rrs.gov (undated).

⁸² For more on dark store developments, see the individual state narratives for 2018 in *State-by-State Property Tax at a Glance*, "Significant Features of the Property Tax," Lincoln Institute of Land Policy and George Washington Institute of Public Policy.

⁸³ Daniel Smith and James Johnson, "Property Taxes Should Reflect Retail's Apocalyptic Times," American Property Tax Counsel, Nov. 14, 2017.

⁸⁴ In addition to the Indiana and Michigan cases described in this section, decisions in Ohio (*Johnston Coca-Cola Bottling Co. Inc. v. Hamilton County Board of Revision*, 149 Ohio St.3d 155 (2017)) and North Carolina (*Matter of Lowe's Home Centers LLC*, COA17-220, (N.C. Ct. App. 2018)) were issued in 2017 and 2018.

⁸⁵ Doug Schneider, "Menards 'Dark Store' Suit Against Howard Headed to Trial in 2018," *USA Today Network*, June 16, 2017.

⁸⁶ "Dark Store Informational Packet," League of Wisconsin Municipalities (May 2017).

⁸⁷ Schneider, "'Dark Store' Cases Could Cost Millions in Taxes," *USA Today Network*, Feb. 13, 2017.

As dark store appeals have continued to gain traction in a handful of states, the issue has drawn national attention. In January credit rating agency Standard and Poor's Global Ratings issued a grim warning to municipal bond investors about the potential ramifications of dark store assessments on municipal credit. Noting the growth in appeals, S&P analysts identified dark stores as an emerging risk that "could have an actual substantial credit impact if it were to hit the right type of issuer at the right time."⁸⁸ Acknowledging the escalating controversy over dark store valuation, the International Association of Assessing Officers formed a special committee on big-box valuation, which released a guide in September 2017 laying out a process by which appraisers can support market value assessments of these properties.⁸⁹

Supreme courts in Indiana and Michigan weighed in on dark store cases in 2017, in both instances allowing lower court rulings to stand. A dark store case brought by Kohl's against Howard County, Indiana, was the first dark store appeal in that state to reach the supreme court. The justices declined to review the case, letting stand a lower court ruling in favor of the retailer. Michigan's Supreme Court declined to hear an appeal from retailer Menards, letting stand a ruling in favor of the municipality.⁹⁰

Michigan, Texas, and Wisconsin considered legislation to address dark store assessments. Michigan H.B. 4397 would have required the Michigan Tax Tribunal, which hears assessment appeals, to make its determinations based on appraisal standards that spell out limited and specific conditions under which sales of vacant property may be used as comparable sales.⁹¹ The legislation, which would have made dark store appeals more difficult for retailers, died in committee, as did similar legislation introduced in 2016. Texas H.B. 27, crafted in support of municipalities, would have limited what properties may be used as comparable sales. While the bill did not explicitly mention vacant

properties, it would have required appraisers to use comparable properties with the same highest and best use and would have excluded from valuations any restrictions on use by subsequent owners in determining highest and best use. The session ended without a vote on the measure.⁹²

Wisconsin's 2017-2018 regular legislative session ended without lawmakers passing a pair of closely watched bills aimed at dark store assessment. S.B. 291⁹³ would have reversed the 2008 Wisconsin Supreme Court ruling in *Walgreen Co. v. City of Madison*.⁹⁴ In *Walgreen Co.*, the court ordered use of market rents instead of contract rents in assessing leased properties, a precedent that resulted in scores of lower court rulings in favor of retailers. Contract rent (actual lease paid) is often higher than market rent (the rent the property would bear in an open market) especially in cases of sale-leaseback or build-to-suit transactions in which leases often capture additional costs. S.B. 292, modeled after legislation adopted by Indiana in 2016,⁹⁵ would have favored municipalities by requiring assessments to rely on comparable sales in the same market segment, with the same highest and best use, similar age, condition, and other criteria. The bill specifically prohibited use of dark properties as comparable for properties that are not vacant.⁹⁶ The legislature failed to bring those two bills to a vote by the end of its regular session. An eleventh-hour attempt to attach compromise dark store legislation to another bill failed.⁹⁷ Democrats called on the governor to call a special session to address dark stores in 2018, but no action is likely until the next session.⁹⁸ Lawmakers have vowed to form a committee to study the issue. In November some Wisconsin taxpayers will vote on local referendums calling

⁹²Tex. H.B. 27 (85th Legislature).

⁹³Wis. S.B. 291/A.B. 387 (2017-2018).

⁹⁴752 N.W.2d 687 (Wis. 2008).

⁹⁵Ind. H.B. 1290 (2016).

⁹⁶Wis. S.B. 292/A.B. 386 (2017-2018).

⁹⁷"League of Wisconsin Municipalities Dark Store Statement," Feb. 23, 2018.

⁹⁸Bill Guida, "Sen. Bob Wirth Fails to Get GOP Signatures for 'Dark Stores' Legislation," *Kenosha News*, Feb. 13, 2018.

⁸⁸Brian Tumulty, "How Property Tax Challenges by Big Box Retailers Hurt Municipal Finances," *The Bond Buyer*, Jan. 30, 2018.

⁸⁹"Commercial Big-Box Retail: A Guide to Market-Based Valuation," International Association of Assessing Officers (Sept. 2017).

⁹⁰*Menard Inc. v. City of Escanaba*, 901 N.W.2d 901 (Mich. 2017).

⁹¹Mich. H.B. 4397 (2017).

on the Legislature to act on dark store assessments.⁹⁹

In March Alabama Gov. Kay Ivey (R) signed legislation requiring parties appealing commercial or industrial assessments based on a comparable sale or lease transaction to disclose whether the comparable property was vacant at the time of sale and whether it was subject to restrictive covenants.¹⁰⁰

Conclusion

As this report was drafted, the economic expansion since the end of the Great Recession in June 2009 became the second-longest in U.S. history. If this expansion continues, these property tax issues may be the issues discussed in future editions of this report. If economic growth slows, the stabilizing feature of the property tax relative to sales and income taxes may again be apparent. Whether the economy grows or slows, one overarching question is whether the 2017 federal tax overhaul will put pressure on state and local governments — especially in states with relatively high taxes — to lower their taxes and public spending.

Key Property Tax Developments 2017-2018

Tax Increment Financing Legislation Enacted	School Finance High Court Ruling	Charitable Exemption Court Ruling or Legislation Enacted	Dark Store Court Ruling or Legislation Enacted
9	5	4	5
Colorado Delaware Kansas Kentucky Minnesota Montana North Dakota Vermont Wisconsin	Connecticut Kansas Mississippi Pennsylvania Washington	Illinois Kentucky New Jersey Oregon	Alabama Indiana Michigan North Carolina Ohio

⁹⁹Terry Flores, "Village Board Approves 'Dark Stores' Referendum for Nov. 6 Ballot," *Kenosha News*, June 12, 2018; and Guida, "County Board Puts 'Dark Stores' Loopholes on November Ballot," *Kenosha News*, June 19, 2018.
¹⁰⁰Ala. S.B. 182 (2018 Legislature).

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