

{City of East Lansing}

INCOME TAX FEASIBILITY STUDY | OCTOBER 30, 2016

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Management Summary

Project Scope and Objectives

The City of East Lansing appointed a Financial Health Review Team to examine and advise City Council on the fiscal stability of the City. The Team organized itself into six work groups to explore various options associated with fiscal issues. One of the work groups was tasked with examining City revenues and identify options for consideration by Council. An income tax is one of the options that is available to cities in Michigan.

The City of East Lansing retained Plante Moran to analyze the revenue potential that could result from instituting an income tax in the City. This brief includes the findings from that analysis and identifies major policy considerations that may inform deliberations by City policy makers regarding the feasibility of instituting an income tax. We present these findings to assist in deliberations but do not advise whether or not to institute an income tax.

Project Approach

Plante Moran has developed income tax estimates for many Michigan cities. Over time, the model we use has been improved and enhanced. It is reliant on data from the U.S. Census Bureau and survey information from taxing jurisdictions.

East Lansing leadership participated in project kickoff activities and review of the proposed model that have been used to generate estimates. In addition, members of the Revenue Options Workgroup evaluated projections and advised on data sources and local demographic issues. These individuals included:

- Michael Moquin, Financial Health Review Team Chair
- Jill Rhode, Revenue Options Workgroup Chair
- George Lahanas, City Manager
- Mary Haskell, Finance Director
- Jill Feldpausch, Treasurer/ Deputy Finance Director
- Robert Kleine, Revenue Options Workgroup Member

Conclusions

Our analysis indicates that a 1.0% tax on income of residents and businesses (0.5% on non-residents) with a \$600 exemption for individuals and seniors would produce approximately \$10.4 million in revenue per year for the City. Administering the tax would likely cost the City \$0.4 million per year, which would net the City an estimated \$10.0 million per year.

The detailed analysis is included in Appendix A. The breakdown of revenue by source is:

- Residents: \$5.3 million
- Non-residents: \$4.7 million
- Businesses: \$0.4 million
- Total Revenue: \$10.4 million
- Administrative Costs: \$0.4 million
- Total Net Revenue: \$10.0 million

In addition, the City has a policy choice to make regarding exemption amount. Six options were explored to demonstrate the impact that exemption amount can have on total net revenue. This summary is below.

- \$600 exemption: \$10.0 million (total net revenue)
- \$1,200 exemption: \$9.6 million
- \$1,500 exemption: \$9.4 million
- \$1,800 exemption: \$9.2 million
- \$2,400 exemption: \$8.8 million
- \$3,000 exemption: \$8.4 million

City Income Tax in Michigan

Under Public Act 284 of 1964, Michigan cities are able to tax income provided that the issue is approved by city voters. East Lansing can tax at a maximum rate of 1.0 percent for individuals and corporations that reside in the City and 0.5 percent for non-residents who earn income in the City. Taxable income includes salary, wages, dividends, interest, net capital gains, net profit from rental properties, and other income. Income not subject to tax includes pensions and retirement benefits, unemployment benefits, armed forces compensation, and employee reimbursement for business expenses.

The Public Act states that the non-residential tax must be set at no greater than half the rate of the tax for residents. Individuals who live in one taxing jurisdiction and receive income in another taxing jurisdiction cannot be taxed twice – the city of employment takes precedence¹ and the taxpayer can deduct that payment on income tax of their city of residence. Net profits of a corporation within the City are also taxable at the same rate as residents. Businesses that conduct part of their operations in the City are required to account for and report the City operations only. Businesses are also required to withhold the appropriate income from their employees and report this to City officials.

Currently, twenty-two Michigan cities² tax income and all have done so for at least twenty years. Each taxes at one percent for residents unless a greater amount is allowed under the statute. Population and date of instituting an income tax impact the allowable rate; for East Lansing, the maximum allowable rate is one percent for residents and 0.5 percent for nonresidents. Cities do vary considerably on the exemption amount for dependents – from \$600 to \$3,000. There is no maximum exemption amount and the minimum amount is \$600, which is also the most common amount. This, along with whether to allow additional exemptions, would be established by City policy. Those who may receive an additional exemption include taxpayers 65 years of age or older, those who are blind, paraplegic, quadriplegic, hemiplegic, disabled, and/ or deaf. It is important to note that an exemption is an amount subtracted from income and not from amount taxed, so one \$600 exemption would result in \$6 less in tax at a 1 percent tax rate.

Of the twenty-two cities with income tax, Ionia was the last to adopt the tax in 1994.³ Since then, several cities (Benton Harbor, Mt. Pleasant, Ypsilanti, Sturgis, Kalamazoo, Adrian, Ann Arbor, and others) have considered an income tax but none have approved it.

East Lansing also evaluated income tax twenty years ago and Council at the time decided not to refer the issue to the public for a vote. Plante Moran was retained to develop projections at this time. The following year, graduate students at MSU's public policy program also conducted a study⁴ of municipal income tax in partnership with East Lansing.

¹ On The Map (<http://onthemap.ces.census.gov/>) includes updated commuting patterns based on Census data. According to this tool, there are an estimated 2,773 individuals who commute from East Lansing to either Lansing, Detroit, or Jackson. Individuals who commute to other taxing jurisdictions are not included.

² Cities include Albion, Battle Creek, Big Rapids, Flint, Grayling, Hamtramck, Hudson, Ionia, Jackson, Lansing, Lapeer, Muskegon, Muskegon Heights, Pontiac, Port Huron, Portland, Springfield, and Walker tax at a rate of 1 percent for residents; Detroit, Grand Rapids, Highland Park and Saginaw tax at a higher rate as permitted by statute.

³ *Outline of the Michigan Tax System: 2016 Edition*. Citizens Research Council of Michigan, April 2016.

⁴ Policy Analysis Practicum class in the Program in Public Policy and Administration. *Feasibility Study: A Local Income Tax in East Lansing*. Michigan State University, 1999.

Income Tax Assumptions

Michigan statute allows a city to establish its own income tax rate, provided that the rate is below one percent of income for residents and businesses and that the rate for non-residents is set at half of the rate for residents. Similarly, the statute provides a minimum exemption rate of \$600. For the revenue estimate, Plante Moran assumed that East Lansing's policy choices would follow the pattern that is most common among other taxing jurisdictions and established the following assumptions in the estimate:

- Tax rate would be one percent rate for residents and businesses
- Tax rate would be 0.5 percent for non-residents
- The exemption amount would be \$600 (alternate rates were conducted and the results of this appear in the management summary)

East Lansing's demographic and economic characteristics presented a number of challenges to estimating income tax potential. Notably, the presence of Michigan State University generates a transient, seasonal, and highly mobile student population that presents difficulties for estimating tax potential as well as for collecting and enforcing taxes by the City. In addition, East Lansing has a larger commuter population than many other jurisdictions. These challenges were discussed with the Revenue Options Workgroup. An initial collection rate of 70% for residents and 65% for non-residents is based on this population dynamic. It is possible that a concerted outreach and enforcement effort by the City could increase this collectability rate.

Data sources to be included in the revenue estimates were also discussed at length with the City. Initially, proxy measures from U.S. Census data were proposed as indicators of what the total likely income for the community is. City officials noted that the Michigan Treasurer publishes a report⁵ of actual filings for state income tax and sorts this data by school district. While Plante Moran believes that this is an improved data source, there are three notable shortcomings:

- City boundaries and school district boundaries are not identical. Land differences are in the Red Cedar and Glencairn schools in the Southwest, the Donley and Whitehills schools in the Northeast, Okemos Public Schools in the Southeast and East Lansing School District in the Northeast.
- The school district of the tax payer is self-reported on state filings which may introduce additional error.
- Income tax can be filed jointly or separately by married couples and this does not coincide directly with number of households, as reported by the U.S. Census.

City officials and Plante Moran weighted these data sources and agreed that the benefits of using actual filings outweighed these limitations. The adjusted gross income (AGI) from the Michigan Treasury report is included as the source of estimate. The average AGI is adjusted by applying the proportion of Statewide AGI that is attributable to pension benefits, which cannot be taxed by a municipality but can be taxed by the State. This proportion (6.1%) was supplied by the Revenue Options Workgroup based on State Treasury Department information.

For the remainder of the variables, major data elements are found in three different U.S. Census sources that are readily available: the 2010 Census, the 2010-2014 American Community Survey

⁵ Office of Revenue and Tax Analysis Michigan Department of Treasury. "Michigan Income, Income Tax, and Property Tax Credits by School District 2012."

and the Bureau's On the Map tool. 2010-2014 Estimates were used when available. When estimates were not available, Plante Moran used 2010 Census data. Table A below identifies the data points used and their sources.

A final source of information was supplied by other taxing jurisdictions. This included a review of municipal budgets and financial reports as well as with the most similarly sized jurisdictions of Jackson, Port Huron, and Muskegon. These interviews combined with data from previous interviews with other jurisdictions to conclude on the following assumptions:

- .077% of business sales would generate income tax
- The cost to administer a tax would be approximately 4 percent of revenue generated

Administrative Issues

If City Council and East Lansing voters vote to institute an income tax, there are some administrative issues that the City should consider. These issues are at purview of City Council and are presented here for your information and consideration. With the exception of the first three points, costs incurred with the items below have been incorporated into the estimate based on experiences shared by other jurisdictions.

- **Project Costs.** When beginning a new program, there are project costs associated with program design, setup, and initial administration. These costs are not included in this estimate, as there are no recent examples of cities who have adopted an income tax. City Council members are advised to develop a project plan and budget for these one-time costs before moving forward. Public engagement and communication about compliance will be an important part of this step.
- **Potential Loss of Residents and/or Businesses.** There may be concerns that an income tax has the potential to drive businesses and residents from East Lansing, which would deepen rather than help the City's fiscal problems.
- **425 Agreements.** The City has several 425 Agreements with neighboring jurisdictions. Businesses and residents in these areas would be required to pay an income tax. However, in cases in which the properties revert to the township, the income from residents and businesses would no longer be taxable.
- **Administrative Costs.** Other municipalities have created positions to monitor, account for, and audit the tax. In the past, this cost was high (7.68 percent) relative to the revenue received. Due in part to a variety of efficiencies, this has decreased to 4 percent in our recent surveys of taxing jurisdictions.
- **Michigan State University.** Over half of the jobs in East Lansing are by a single employer. Administratively, this means that the majority of income tax receipts will likely come from a single employer's withholding policy.
- **Temporary Population.** According to the Census Bureau, 65% of housing units are renter-occupied. Students occupy many of these and are likely to be residents of East Lansing for a relatively short time and are likely to change place of residency several times while students. Enforcement of this population could cause challenges to the City.
- **State Filing.** The State has invested in processing municipal income tax payments. The State began processing Detroit income tax payments in 2016 as a pilot project. Reportedly, it is the State's intention to offer other municipalities this service in the future.
- **Software.** Twenty municipalities use the same software system (Innovative Tax Software) to track tax receipts and compliance. While Plante Moran will not endorse a particular vendor, we do note that the majority of income tax jurisdictions use the same product. Some also contract with this firm for administering the tax.
- **E-Filing.** As many as one-third of returns are filed electronically. E-filing has the potential to reduce administrative burden. However, it does require interaction with software vendors.
- **Rental Properties.** The net profit from rental properties is taxable. As a practical matter, other communities have found that income tax collections from this source are limited.
- **Cash Flow.** Most cities receive the majority of cash during months on or around the dates that property tax bills are due. Income tax is received throughout the year (primarily through employer withholdings) and is more normalized by month.

- **Appeal Process.** City Council must appoint a three person income tax board of review to handle appeals. This board operates in a manner similar to the property tax board of review.

Policy Considerations

In addition to general operational issues, there are several policy issues that the City might wish to consider.

- **Impact to City of Lansing.** An estimated 4,515 Lansing residents commute to East Lansing for employment. Currently, these individuals are taxed at 1 percent by the City of Lansing. If East Lansing institutes an income tax, these individuals would be required to file twice – once for Lansing and once for East Lansing – and would be taxed at 0.5 percent by both jurisdictions. This would result in an estimated net loss to Lansing of \$0.8 million. Appendix B details this calculation.
- **Rate and Exemption Amounts.** Our estimates assume a 1.0 percent tax rate for residents and a \$600 exemption. Both items are most common among income taxing cities but East Lansing can change these as allowed by statute.
- **Enforcement.** The City has a choice about whether to handle failure to pay in civil court or criminal court. Most cities choose civil court. Grand Rapids chooses criminal court and believes it has a much higher compliance rate. Lansing uses a combination of criminal and civil court.
- **Audit.** For effective administration and compliance, tax returns need to be audited. The determination of the level of investment in auditing returns resides with the City.
- **Policy.** In general, funds produced from an income tax would be accounted for within a city's general fund and could be used for any legal purpose.
- **Referendum.** If City Council believes an income tax is sound policy, they will need to adopt an ordinance that details the income tax rate, exemption rate, etc. Signatures will then need to be gathered in accordance with PA 284 as revised to hold an election. At least ten percent of registered electors who voted in the last general municipal election are required to place the issue on a ballot.

Appendix A

APPENDIX : Income Tax Collections - AGI and State Filings	
RESIDENTS (ALL)	EAST LANSING
Average Gross Income (AGI)	\$ 67,926
# Returns	14,883
Total Est. Income (Filings)	1,010,942,658
Minus Est. 6.1% retirement filings	61,667,502
Total Est. Taxable Income	\$ 949,275,156
Est. Population	48,471
Est. # of Direct Exemptions	48,471
Est. Dependent Exemptions	3,635
Est. Senior Citizen Exemptions	4,835
Other Exemptions	0
Total Estimated Exemptions	56,941
Exemption Rate	\$ 600
Est. Exemption Amount	\$ 34,164,838
Estimated Taxable Income	\$ 915,110,318
Tax Rate	1%
Est. Tax Potential	\$ 9,151,103
Est. Collection Rate	70%
Est. Total Tax Residents Pay to ALL Taxing Jurisdictions	\$ 6,405,772
RESIDENTS (WORK IN OTHER TAXING JURISDICTIONS)	
# Commuters TO Lansing	2,234
# Commuters TO Other	995
AGI (East Lansing)	\$ 67,926
Total Income	\$ 219,333,054
Tax Rate to Other Jurisdictions	-0.5%
Est. Tax Adjustment	\$ (1,096,665)
Est. Total Tax Received by EAST LANSING from Residents	\$ 5,309,107

NON-RESIDENTS		
Average AGI (Ingham County)	\$	59,281
# Other Commuters TO East Lansing		20,903
# Lansing Commuters TO East Lansing		4,515
Est. Commuter Income	\$	1,506,804,458
# Total Commuters		25,418
x Average Family Size (Ingham County)		3.06
Estimated # of Direct and Dependent Exemptions		77,779
Estimated Senior Citizen		2,669
Total Estimated Exemptions		80,448
Exemption Rate	\$	600
Est. Exemption	\$	48,268,782
Estimated Taxable Income	\$	1,458,535,676
Tax Rate		0.5%
Est. Tax Potential	\$	7,292,678
Est. Collection Rate		65%
Est. Total Tax Potential		4,740,241
BUSINESS		
Reported Sales	\$	433,498,000
Collections as % of Sales		0.077%
Est. Tax Potential	\$	335,126
ADMINISTRATION COSTS		
Est. Total Revenue	\$	10,384,474
Est. Admin Rate		4%
Est. Admin Cost		415,379
TOTAL NET REVENUE POTENTIAL	\$	9,969,095

Appendix B

APPENDIX B: Impact to City of Lansing		
# Commuters TO East Lansing		4,515
Average AGI (Lansing School District)	\$	36,059
Total Income	\$	162,806,385
Tax Rate to Other Jurisdictions		0.50%
Est. Tax Adjustment (to Lansing)	\$	814,032

Appendix C

City	Total Revenues	Income Tax Revenues	Percentage	Millage (Operating)	Year (Source)
Albion	\$ 6,878,563	\$ 925,010	13%	11.9736	2015 (Audit)
Battle Creek	\$ 60,110,636	\$ 16,475,837	27%	10.307	2015 (CAFR)
Big Rapids	\$ 9,486,407	\$ 2,020,558	21%	15.5863	2014 (CAFR)
Flint	\$ 83,101,127	\$ 14,012,171	17%	7.5	2015 (CAFR)
Hamtramck	\$ 23,737,000	\$ 2,015,000	8%	19.2403	2013 (Audit)
Jackson	\$ 39,686,649	\$ 8,806,662	22%	6.72	2015 (CAFR)
Lansing	\$ 100,360,365	\$ 29,850,755	30%	19.44	2013 (CAFR)
Lapeer	\$ 13,200,000	\$ 2,760,740	21%	9.8	2015 (CAFR)
Muskegon	\$ 34,695,000	\$ 8,478,000	24%	10	2015 (CAFR)
Pontiac	\$ 45,707,871	\$ 11,385,266	25%	11.2737	2015 (CAFR)
Port Huron	\$ 29,942,432	\$ 6,431,121	21%	11.2696	2015 (CAFR)
Springfield	\$ 3,618,666	\$ 934,368	26%	14.8743	2015 (CAFR)
Walker	\$ 18,563,702	\$ 9,969,054	54%	1.336	2015 (Audit)

{THANK YOU!}

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