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LSC presentation on H.B. 920 tax reduction factors House Ways and Means Committee March 14, 2023

Chair Roemer, Vice Chair Merrin, Ranking Member Troy, and the members of the House Ways and Means Committee, my name is Sam Benham and I have been asked to give a brief presentation on the H.B. 920 tax reduction factor.¹ I am LSC's Division Chief of Taxation and Economic Development, and I had the privilege to staff the House Ways and Means committee for seven years, until 2019.

The H.B. 920 tax reduction factor — named after the bill that first enacted it in 1976 — plays a significant role in how property tax bills are calculated and liabilities are allocated, so it is helpful to understand how it operates. The reduction factor interacts with many different parts of the property tax system, so it is difficult to explain the rule without diverting into other topics. I will, however, confine this presentation to a basic explanation of the tax reduction factor, discuss the role it plays in Ohio's property tax system, and give a brief history of the factors.

I am happy to answer any questions you may have at the conclusion of this presentation, with the understanding that, due to the complexity of the topic, I may be unable to immediately answer your question. But, if that happens, we will get back to you. You also have my contact information, so please contact me if you think of a question later on.

Purpose

As a jumping off point, I'm going to discuss the overall purpose of the H.B. 920 tax reduction factor. Although the law's operation appears complex and sometimes may yield unexpected effects, the purpose of the tax reduction factor is very simple: to prevent appreciation in real property values from causing commensurate increases in real property taxes. The tax reduction factor law acts as a sort of inflation indexing adjustment, ensuring that rising property prices alone do not cause property tax increases. Without H.B. 920, an increase in property values of, say, 10% would be translated into a 10% increase in property taxes. H.B. 920's purpose is accomplished by essentially stabilizing the amount of taxes that may be charged against the existing stock of real property. When the value of that stock of property appreciates, H.B. 920 ensures that the total amount of taxes charged against that property remains about the same.

¹ Codified in R.C. 319.301.

Operation

The simplicity of the tax reduction factor law's purpose is easily obscured by the details of how it actually operates. The law is complicated by the following factors:

- Some property tax levies are exempted from reduction;
- The reduction applies separately to two distinct classes of real property;
- The law distinguishes merely inflationary increases in property values from increases resulting from newly built property; and
- The reduction is suspended in a school district if it would deprive the school district of a minimum level of operating revenue.

I will now explain each of these qualifications and its underlying rationale, after a statement of the basic rule by which the tax reduction factor operates.

Basic rule of operation

The basic operating rule involves a comparison between the taxes charged against real property in one year and the taxes charged against that same property in the preceding year: if the amount of taxes before applying the tax reduction factor for the current year, or the gross tax amount, is greater than the amount of taxes charged after applying the factor in the preceding year, then the current year's gross tax amount is reduced by the difference. This difference, when expressed as a percentage of the current year's gross taxes, represents the tax reduction factor. The tax charged against each parcel of real property located within the same taxing district is reduced by this percentage. The reduction is achieved by crediting each real property owner's bill with this percentage; the reduction is not achieved through a reduction in the tax rate. I'll say that again — the tax reduction factor is technically a billing credit, not a reduction in the voted rate of a levy. Now, the qualifications:

Qualification 1: the reduction factor does not apply to every kind of tax levy

The following kinds of levies are exempted from the H.B. 920 tax reduction law:

- Levies within the 10-mill limitation on unvoted taxes, often called "inside millage";
- Levies provided for under a municipal charter, often called "charter millage";
- Levies to pay debt charges; and
- Levies imposed at whatever rate is necessary to raise a specified sum of money, which are often called "fixed sum levies," and which most notably include school district emergency levies.

The rationale for the first and second exemptions was probably to allow a limited degree of inflationary growth in property taxes. The rationale for the third and fourth exemptions is that it simply is not necessary to restrain inflationary tax growth if a levy is designed to raise no more than a specified sum of money.

So what kinds of levies are subject to the tax reduction factors? Voted levies above the 10-mill limitation that are imposed at a fixed rate, often called “fixed rate levies.” Currently, these levies, in the aggregate, make up the majority of millage levied.

Qualification 2: For each levy, there is a tax reduction factor for each of two classes of property

Current law divides real property into two classes specifically and exclusively for the purpose of computing separate tax reduction factors. “Class I” property is real property used for residential and agricultural purposes, and “Class II” is all other real property, consisting primarily of property used for commercial, industrial, or public utility purposes, and mineral rights.

This classification prevents property value inflation in one class of property from influencing the degree of the tax reduction for the other class. Because of the differing forces at play in different segments of the real estate market, Class I property generally tends to experience greater inflation than Class II property. This means that the reduction in taxes for Class I property is greater than the reduction for Class II property. If property was not separated into two classes, the overall reduction in taxes would not be enough to offset the inflation affecting Class I property, and would overcompensate for the relatively lower inflation affecting Class II property. Class I property owners therefore would tend to bear a greater share of the overall property tax burden, a burden that would gradually increase through the passage of years. In fact, this is exactly what happened in the few years after H.B. 920 was enacted, prompting the division of real property into the two separate classes, which I’ll discuss later.

Qualification 3: The comparison is made for the same stock of real property; new property is excluded from the comparison in the first year it is added

To accomplish its purpose, the tax reduction factor must be computed on the basis of the same stock of property as existed in the preceding year. This stock of property consists of real property that was taxable in the preceding year, that continues to be taxable in the current year, and that has not changed from one class to the other since the preceding year; for example, it is not former farmland converted to a warehouse or factory within the last year. In other words, the tax reduction is computed only on the basis of property within the same class carried over from the preceding year to the current year; accordingly, it is referred to as “carryover property.” There is Class I carryover property and Class II carryover property.

If new property is added to a class, either because it is newly constructed or it has changed classes, it becomes part of the carryover property of that class in the year after it is first added to the class. The total value of carryover property therefore increases. This has the effect of increasing the total amount of taxes that may be collected from that class of property — a revenue increase that H.B. 920 purposely accommodates, since it results from an expansion of the tax base rather than an inflationary increase in property values.

Without this distinction, new buildings, structures, and additions that become taxable for the first time in the current year would cause the current year’s unadjusted tax amount to be overstated, which, in turn, would cause the reduction factor percentage to be greater than it

should be; the reduction then would be compensating not only for inflationary increases in property values, but also for an expansion in the taxable property base.

Qualification 4: the tax reduction factor is suspended at the point at which it would deprive a school district of a minimum level of operating funds

This qualification is known as the “20-mill floor” since it is intended to guarantee that school districts have at least 20 mills worth of property taxes available to pay operating expenses. The 20-mill floor works by suspending the tax reduction factor once the reduction has reduced the total taxes charged against a class of property for current operating expenses, including both inside and voted fixed-rate millage, to 2% of the class’s taxable value, which is equivalent to 20 mills in property taxes. In most cases, the 20-mill floor does not mean that the tax reduction does not apply at all; in fact, the reduction does apply in most cases, but the reduction is not as great as it would be if the floor did not intervene to diminish the extent of the reduction. A separate 2-mill floor applies to joint vocational school districts.

Decreasing property values

Before discussing the history of the tax reduction factor, I will touch on how the tax reduction factor would operate if the aggregate taxable value of real property, which is currently 35% of appraised fair market value, decreases for any reason. Recall that the tax reduction factor acts on the aggregate amount of taxes charged by each levy to prevent the total amount of revenue from a levy in any year from exceeding the prior year’s revenue. Revenue from a particular levy may increase only if new property is constructed. Apart from new construction, when the aggregate taxable value of property increases, the reduction factor maintains total revenue at the same level. If the aggregate taxable value of property were to decrease from one year to the next, the revenue from a levy would be maintained at the same level, and would continue to be maintained at that level until the aggregate taxable value of property declines to completely offset prior increases in the aggregate value from the time the levy was originally imposed. If the aggregate property value declined for any reason to the point that the recalculated value is less than the original value, the aggregate revenue collected would then decrease accordingly.

In other words, the tax reduction factor increases as taxable values increase. Should the aggregate taxable value of property decrease for any reason, the tax reduction factor will actually decrease so that the same amount of revenue is collected, up to the point the reduction factor equals zero and the applicable levy is collecting its full, voted rate of tax. In no case, however, will the tax reduction factor be negative, so property owners would not pay more than the rate of tax they originally voted for.

Legal and constitutional history

Following that summary of how tax reduction factor law operates, I’d like to give some historic context for why some of these qualifications are part of this law. I will also discuss how the Ohio Constitution limits the General Assembly’s power to modify the tax reduction factor.

The predecessor: millage reduction system

As I mentioned earlier in my presentation, modern tax reduction factor law was enacted by H.B. 920 in 1976. The immediate predecessor to H.B. 920 was a millage reduction system. I don't want to say too much about that, other than that the key distinguishing factor was that the millage reduction factor actually did decrease property tax rates. Under this system, the tax rate on all taxable property — real and tangible personal — was rolled back in proportion to the increase in the valuation of *real property*. For example, if, after a reappraisal, real property values increased by 8%, then the millage rate was rolled back by 8%. It was under this system that several features of the current tax reduction factor originated. For example, the exemption of inside millage, the allowance of growth for new improvements, and the 20-mill floor all existed in some form in the millage reduction system.

The biggest drawback of the millage reduction system was that it shifted the tax burden from tangible personal property to real property. This occurred because the millage rollback applied equally to all property — real and personal — even though the rollback was linked only to appreciation in real property values.

The process by which the millage reduction system shifted the tax burden onto real property continued into the 1970s. That decade witnessed unusually high rates of general price inflation, including rapid inflation in real estate values. The resulting increase in real estate taxes was not being sufficiently moderated by the millage reduction law because of the tax burden shifting problem inherent in the system. The deficiencies of the millage reduction law became ever more apparent when the Ohio Supreme Court ordered all real property in the state to be assessed at a uniform percentage of true value in money, or its appraised fair market value. This order was the culmination of a series of court decisions, collectively referred to as the “Park Investment” decisions, requiring the overhaul of the state's system for assessing real property for taxation. The system had been found to allow unequal and nonuniform assessment practices to persist throughout the state in violation of the Ohio Constitution's “uniform rule,” which requires that “Land and improvements thereon shall be taxed by uniform rule according to value”

H.B. 920 of the 111th General Assembly

The idea at the heart of H.B. 920 was to limit taxes directly rather than through a rollback of the tax rate, and to do so only for real property. This approach avoided the tax burden shifting problem caused under the millage reduction system. But, within a couple years of H.B. 920's inception, a new tax burden shift problem emerged: H.B. 920 was contributing to a gradual shift in the tax burden from commercial and industrial real property to residential real property.

The shift was analogous to the shift that occurred under the millage reduction system, in the sense that one kind of property appreciated at a faster pace than another kind, but the tax reduction mechanism treated both kinds the same; this, in turn, caused the tax reduction to be too low for the more rapidly appreciating property and to be too high for the more slowly appreciating property. In the case of the original H.B. 920 law, residential property tended to appreciate at a faster pace than commercial and industrial property, but a single tax reduction percentage, determined by the increase in the value of all property, was computed for and

applied to all property. Thus, if commercial and industrial property increased in value by 5% per annum and residential property increased by 8% per annum, the tax reduction percentage would be somewhere between 5% and 8%. Commercial and industrial property therefore received a reduction greater than the 5% growth rate, and residential property received a reduction less than the 8% growth rate. Over time, this was bound to cause residential property to bear an increasingly larger share of the overall tax burden.

Article XII, Section 2a, Ohio Constitution

The solution to this new tax burden shifting problem came in 1980, but it was not simply a matter of rewriting H.B. 920. The uniform rule of the Ohio Constitution stood in the way of the General Assembly simply amending the H.B. 920 law to compute different tax reduction percentages for different classes of property.

Consequently, a constitutional amendment was required to prevent the emerging tax burden shift effects of the original H.B. 920 law. The constitutional amendment was proposed by the General Assembly and adopted by voters in a statewide election in November 1980. The constitutional amendment authorized the General Assembly to divide real property into two separate classes exclusively for the purpose of computing separate tax reduction percentages for each class. The General Assembly immediately used this new constitutional authority to amend the original H.B. 920 law accordingly. This legislation prevented the tax-limiting benefits of H.B. 920 from being disproportionately shifted from residential property to commercial and industrial property.

It should be noted that the tax reduction factor is not mandated by the Ohio Constitution. What the Constitution does require is that if the General Assembly enacts a law classifying real property in order to compute separate tax reductions, the tax reductions must be made precisely in the manner prescribed by the Constitution.

Conclusion

I've now discussed the purpose and operation of the tax reduction factor and given a brief summary of its legal and constitutional history. This concludes my remarks on the tax reduction factor, and I am happy to take any questions you might have, with my earlier caveat that there may be some questions that I may not be able to answer immediately due to the complexity of this topic.