

Property Taxation as a Field of Study

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Introduction to Legal Issues in Property Valuation and Taxation

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Introduction

Property tax studies offer several perspectives on current political and economic developments in the United States. At the most basic level, they provide information on a stable, longstanding and endlessly controversial revenue source that serves as a mainstay of autonomous local government finance in this country. More generally, any recurrent ad valorem tax raises assessment problems which yield rich material for the study of valuation principles critical to many areas of taxation, finance, economics, and commerce. Finally, this tax brings into sharp focus many political issues concerning payment for government services.

Two central characteristics shape the property tax in this country: its local administration and its nature as an asset tax. A tax on real estate can be administered at the local level, and so provide a city, town or school district with an autonomous revenue source. This contribution to independent local government is balanced, however, by the negative reaction of property owners to a tax levied on a nonliquid asset and collected in a small number of highly visible installments.

Political discontent with the property tax also has wider policy implications. The feasibility of taxing nonliquid assets is a particularly significant issue in an era of decreasing reliance on progressive taxation and increasing reliance on regressive consumption taxes and fees. Asset taxation, whether through a recurrent ad valorem tax or in another form, such as an estate tax, can mitigate the increasing concentration of wealth that accompanies a regressive tax structure. The history and travails of the property tax as a large-scale functioning asset levy bear on the feasibility and acceptability of any form of wealth taxation. The practical political experience of property tax administration can also enrich abstract public finance analysis. For example, local tax officials are keenly aware that the theoretical virtue of visibility, or "transparency," in taxation has served to increase public discontent with property taxes relative to less apparent consumption taxes, payroll taxes, or income taxes withheld at the source.

Any ad valorem tax raises problems of tax base measurement or valuation. Valuation issues are critical to numerous governmental and commercial transactions, from business negotiations to the calculation of awards in eminent domain takings, from the measure of damages in tort claims to rate-setting for public utility services. In this way property tax cases can yield insights into the valuation process with utility far beyond the sphere of taxation alone. The annual assignment of market values to large numbers of taxable parcels provides courts with a vast array of disputes for consideration and decision.

Perhaps the most significant issue raised by the valuation process concerns the definition of property itself. Any calculation of fair market value relies, even if implicitly, on a prior decision as to which rights and interests constitute the property being valued. This inquiry can be confined to a single question, such as whether the provisions of an unfavorable lease affect valuation for tax purposes. It can also encompass a broad range of evolving issues concerning private rights and public restrictions, such as liability for remediation of toxic contamination, responsibility for historic preservation, or the effect of innovative planning techniques such as transferable development rights. As the concept of property as a social and political phenomenon changes, the process of valuing and taxing that property must change as well.

Many political issues connected with the property tax concern its role as the mainstay of independent local government finance. The property tax no longer supplies the major portion of local government funds from all sources, but it represents the largest single source of autonomous local revenue. The straitened state budgets of the 1980s helped dramatize the importance of this function, as states reduced local aid even as the federal government eliminated revenue-sharing. Such measures impressed on localities their need for funding not contingent on decisions by another level of government.

More generally, the operation of the tax illuminates political choices as to the distribution of the benefits and burdens of self-government. For example, by effectively freezing most valuations until property is sold, the California tax limitation measure known as "Proposition 13" provided a clear statement concerning the relative tax burdens to be borne by long-time residents and new arrivals. Throughout the nation, use of the property tax to finance education has sparked debate as to the distribution and redistribution of wealth across jurisdictional and generational lines. The adoption of preferential tax systems for agricultural and open-space land in each of the fifty states represents a land-use decision, just as tax-relief measures for the elderly, for veterans, or for homeowners generally reflect community values. None of these elements is static, and their evolution through periods of changing fiscal, political, and even demographic patterns offers insight into civic culture as it develops over time.

The Property Tax as a Local Tax

The property tax is the primary local tax in the United States, providing the major portion of independent local government revenue in forty-eight of the fifty states.¹ The important strengths of the property tax have kept it operative in various forms since colonial times. Its equally significant drawbacks have made it a focus of popular discontent, particularly during periods of heightened anti-tax sentiment. Both its

¹In 1990, the property tax provided more than 50 per cent of total local tax revenues in all states except Alabama and Louisiana. Advisory Commission on Intergovernmental Relations [ACIR], *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 102.

advantages and its problems are closely related to the nature of a recurrent ad valorem tax, especially one limited to a specific asset.

A major advantage of a real property tax is the relative ease with which land and buildings can be located and identified, and their stability over time. The immobility of real estate compared, for example, to income or sales prevents simple migration to other jurisdictions in response to the tax, although in the long run investment can shift to other locations. Immobility also reduces the problem of tax-base allocation, which can become extremely burdensome to taxpayers and administrators alike when sales or income-producing transactions span numerous small jurisdictions. The problem of collecting tax for hundreds or thousands of local districts has been a powerful argument against requiring mail-order retailers to collect sales and use taxes for jurisdictions in which their customers live.² Similarly, local and state income taxes can require apportionment of income earned through work in multiple sites.³ Finally, an immovable asset also provides a source of collateral for taxes due from the owner. Unpaid taxes can be secured by a lien on the property, with potential foreclosure and sale to pay this debt. These features recommend the tax as a source of autonomous revenue for local governments, which often have neither the economic base nor the administrative capacity for efficient sales or income taxation.

Along with these advantages, a tax on nonliquid assets also presents important difficulties. A recurrent asset tax can encounter resistance when it requires payment from an owner who has realized no increase in net wealth, either through property appreciation or income. Property appreciation itself can present other problems. In times of rising market values, taxpayers' assessments may increase without any corresponding change in the income from which they pay the tax. The need to sell an asset in order to pay tax on it is problematic in any circumstance, and never more so than in the case of a residence. In theory, the tax rate can drop as property values rise, leaving actual tax bills and total collections unchanged. Revenue pressure often delays or inhibits rate reductions, however, particularly when value increases are not distributed uniformly across all taxable properties. If only certain portions of a jurisdiction experience sharp price inflation, it may not be possible to reduce tax rates across all sectors in order to prevent a rapid rise in tax bills for the neighborhoods or property types undergoing unusual increases in value.

A disparity between cash income and property value can cause special problems for retired and elderly taxpayers, farmers owning land on the urban fringe, and homeowners in times of rapid housing inflation. The introduction of many tax limitation

²See *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992).

³For criticism of efforts by Philadelphia and New York to enforce non-resident income taxation, see G. Henderson, "All Aboard the Tax Express!" *State Tax Notes*, January 28, 1993, 93 STN 18-25 ([W]hile our competitors in the European common market are working to reduce the barriers to commerce within their common market, we seem to be moving in the opposite direction.")

measures in the mid-1970s, for example, coincided with a near doubling in the market value of single-family homes from 1976 to 1981.⁴ The political difficulties these cases present are obvious, for they affect groups that are among the most influential in the electorate. They also raise a question as to the role of financial intermediaries, such as banks. How should the availability of loans secured by increased property value affect the problem of liquidity? Few elderly taxpayers have taken advantage of statutory provisions allowing their unpaid property taxes to accrue as long-term low-interest loans secured by their property. This suggests that political resistance to asset taxation stems as much from reluctance to diminish the net value to the owner and his or her heirs as it does from the problem of liquidity itself.

Because the advantages of the property tax are so closely tied to the autonomy of local governments, it is not surprising that nearly all its revenue accrues to cities, counties, school districts, townships, and special districts. In 1990 more than 96 per cent of all property tax collections in the U.S. supported these local government units.⁵ This represents a dramatic change from earlier times. At the turn of the century, before widespread adoption of sales and income taxes, property taxes represented nearly half of all state revenue.⁶ During the intervening period the portion of *state* tax revenue derived from the property tax has fallen to less than 2 per cent.⁷ At the same time the property tax share of local tax revenue only dropped from 88.6 per cent in 1902 to 74.5 per cent in 1990.⁸ The property tax contributed at least 66 per cent of local tax collections in every region of the country in 1990; in New England, the figure was 98 per cent.⁹

The distinctly local character of the property tax is also due to constitutional limitations on federal taxation of property. Article I, section 9[4] of the U.S. Constitution states: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." The federal income tax is exempted from this apportionment requirement by the Sixteenth Amendment, and the federal estate tax has been held to constitute an excise on the privilege of transmitting property, rather than a direct tax on the property itself.¹⁰

⁴A. Manvel, "House Prices and Property Taxation," *Tax Notes*, July 9, 1984, p. 212.

⁵ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 64.

⁶G. Fisher, "Property Taxation and Local Government: Four Hypotheses," 8 *Property Tax Journal* 113, 119-120 (1989). See generally, U.S. Bureau of the Census, *Historical Statistics of the United States from Colonial Times to 1970*, 1086-1135 (1976).

⁷ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 65.

⁸ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 102; ACIR, *Significant Features of Fiscal Federalism* 1991, Vol. 2, Table 81.

⁹ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 102.

¹⁰In *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921), Justice Holmes rejected the argument that the estate tax constituted a direct tax. In a characteristically peremptory manner, he stated that he was guided "not by an attempt to make some scientific distinction, which would be at least difficult, but on an interpretation of language by its traditional use - on the practical and historical ground that this kind of tax always has

**Percentage of Tax Revenue
Derived from the Property Tax, 1957-1990¹¹**

<u>Level of Government</u>	<u>1957</u>	<u>1990</u>
State and Local Governments.....	44.6%	31.0%
State Governments.....	3.3%	1.9%
Local Governments.....	86.7%	74.5%
Cities.....	72.7%	50.9%
Counties.....	93.7%	73.3%
School Districts.....	98.6%	97.5%
Townships.....	93.6%	92.4%
Special Districts.....	100.0%	70.0%

The Property Tax in Local Government Finance, 1990¹²

	Percentage of Local Government <u>General Revenue</u>	Percentage of Local Government <u>Tax Revenue</u>
United States Average.....	29.2%	74.5%
New England.....	49.0%	98.0%
Mideast.....	31.7%	66.7%
Great Lakes.....	35.2%	81.1%
Plains States.....	31.4%	82.9%
Southeast.....	23.4%	70.2%
Southwest.....	32.0%	78.7%
Rocky Mountain States.....	30.7%	76.4%
Far West.....	20.8%	70.0%

Selected States:

New Hampshire.....	71.1%	99.3%
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been regarded as the antithesis of a direct tax....Upon this point a page of history is worth a volume of logic." *Id.* at 349. Note that customs receipts, which in some respects resembled non-recurrent ad valorem property tax revenue, were by far the most important source of federal government tax funds until the Civil War.

¹¹ ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Table 65.

¹² ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 2, Tables 92 and 102.

Connecticut.....	56.2%	.....	98.5%
New Jersey.....	50.8%	.....	98.1%
Oregon.....	42.3%	.....	89.5%
Michigan.....	40.6%	.....	92.6%
Iowa.....	36.4%	.....	95.9%
Colorado.....	30.7%	.....	68.7%
New York.....	29.5%	.....	61.0%
Georgia.....	25.2%	.....	69.2%
California.....	19.7%	.....	69.1%
Washington.....	18.1%	.....	59.7%
Louisiana.....	15.7%	.....	43.4%
New Mexico.....	11.9%	.....	56.1%

**Real Property, Personal Property, Tangibles and Intangibles:
From a General Property Tax to a Real Property Tax**

The evolution of the property tax from a state tax to a local tax was accompanied by its equally significant transformation from a general tax on real, personal, tangible and intangible property to a tax largely limited to real property alone. Land and buildings form the major part of the property tax base today, together with only selected items of personal property, such as certain equipment, inventories, and automobiles. The 1987 Census of Governments found that locally-assessed personal property constituted only 9.8 per cent of the property tax base in 1986, from 17.2 per cent thirty years earlier.¹³ This shift reflected the changing American economy of the nineteenth century. In colonial times tangible property served as an index of ability to pay, the base for a "faculty" tax imposed "upon every man according to his estate, and with consideration to all his other abilities whatsoever."¹⁴ This was no longer the case in an industrialized economy.

These classifications are rooted in Anglo-American property law, which distinguishes real (or immovable) property, basically land and buildings, from personal (or movable) property,¹⁵ with personalty further divided between tangible and intangible

¹³1987 Census of Governments, Vol. 2, *Taxable Property Values*, Table B. See also S. Gold, "How the Taxation of Business Property Varies Among the States," *9 Assessment Digest* 14 (1987), and A. Manvel, *Paying for Civilized Society* (1986), Chapter 3.

¹⁴J. Jensen, *Property Taxation in the United States* 27 (1931) (quoting the 1634 Massachusetts property tax statute).

¹⁵"Material things, regarded as the objects of legal rights, belong to either one of two classes, that is, they are either (1) land, or things so annexed to land as to be considered a part thereof, or (2) articles of a movable character, not annexed to land.... This classification of the objects of rights, based as it is on an essential difference in their character, was recognized in Roman law and in systems derived therefrom; but in English

property. Tangible personal property includes such items as equipment, machinery, and household effects. Intangible property may be considered in two categories: those intangibles that are valuable in themselves, such as patents, trademarks, and copyrights, and those representing rights in other property, such as stocks, bonds, and bank accounts, and currency itself, which represents a claim against the government that issues it. This distinction between representative and non-representative intangibles has important implications concerning double taxation when tangibles and intangibles are both included in the tax base.¹⁶ This potential dual burden must be recognized when a tax reaches both tangible property and the intangible rights in it. This is the case, for example, when a property tax on the full value of a residence is accompanied by an intangible tax on a mortgage on the same property held by a bank.¹⁷

Types of Real Property and Personal Property

Real Property	Personal Property
<ul style="list-style-type: none"> · <u>Land</u> · <u>Buildings</u> · <u>Fixtures</u> - personal property that is attached to real estate and becomes a part of it. For example, an elevator may be personal property before installation, and real property after it is incorporated into a building. 	<ul style="list-style-type: none"> · <u>Tangible Personal Property</u>, e.g.: <ul style="list-style-type: none"> -Machinery, Equipment -Inventory -Household Goods, Jewelry -Automobiles -Artwork · <u>Intangible Property</u>, e.g.: <ul style="list-style-type: none"> -Goodwill, Going-Concern Value -Licenses, Franchises -Representative Property, e.g., Stocks, Bonds, Bank Accounts, Currency, Notes, Commercial Paper

law it attained a peculiar importance...." H. Tiffany, *The Law of Real Property*, Vol. 1, §1 (3d ed., 1939, by B. Jones).

¹⁶Jens Jensen was one of the first writers to examine this distinction, suggesting that a tax base limited to tangible property and nonrepresentative intangibles would avoid double taxation. "Wealth consists of material things plus such incorporeal rights as do not diminish the rights of others in material things." J. Jensen, *Property Taxation in the United States* 49 (1931).

¹⁷Cases on this point were dealt with in the early annotation, "Taxation in the Same State of Real Property and Debt Secured by Mortgage or Other Lien Thereon as Double Taxation," 122 *American Law Reports* 742 (1939).

A more precise legal formulation equates all property with intangible rights, some relating to physical objects and others to intangibles. For example, the legal philosopher Wesley Hohfeld recognized that the word "property" is used in common speech "to indicate the physical object to which various legal rights, privileges, etc. relate; then again -- with far greater discrimination and accuracy -- the word is used to denote the legal interest (or aggregate of legal relations) appertaining to such physical objects."¹⁸ James Bonbright, a professor of finance at Columbia University, wrote in his classic 1937 treatise *The Valuation of Property*:

Because the law of early capitalism concerned itself so largely with rights of full, undivided ownership, and because these rights attached mainly to specific, tangible objects, like land or chattels, the property rights in these objects were closely identified with the objects themselves....A court, no less than a layman, will sometimes refer to a tract of land or a shipment of wheat as property, and will sometimes refer to the interests of people in this land or this shipment as property.¹⁹

By the post-Civil War period real property and readily identifiable farming equipment were no longer the primary forms of personal wealth in the United States. Yet state and local officials were ill-equipped to assess a comprehensive tax on such items as corporate securities and bank accounts, which could easily be concealed or moved to another jurisdiction. A tax that in form covered all types of property but in fact was limited to real estate and certain specific forms of personal property greatly favored those taxpayers whose major assets took intangible form. The economist Edwin Seligman surveyed tax studies issued from 1872 to 1897 and found that "[e]very annual report of the state comptrollers and assessors complains bitterly that the assessment of personalty is nothing but an incentive to perjury."²⁰ Such an assessment was labeled "a tax upon ignorance and honesty," "corrupting and demoralizing," "a premium on perjury and a penalty on integrity," "a school of perjury, imposing unjust burdens on the man who is scrupulously honest." He quoted an 1897 New Jersey report: "[I]t is now literally true that the only ones who pay honest taxes on personal property are the estates of decedents, widows, and orphans, idiots and lunatics."

Seligman concluded, "[T]he general property tax as actually administered is beyond all doubt one of the worst taxes known in the civilized world....It is the cause of such crying injustice that its alteration or its abolition must become the battle cry of every statesman and reformer."²¹ The success of efforts such as his can be seen in the current exemption of most individual personal property and intangibles.

¹⁸W. Hohfeld, "Some Fundamental Legal Conceptions as Applied in Judicial Reasoning," 23 *Yale Law Journal* 16, 21 (1913).

¹⁹J. Bonbright, *The Valuation of Property*, Vol. 1, at 100-101 (1937).

²⁰E.R.A. Seligman, *Essays in Taxation* 27-28 (10th ed. 1931) [citations omitted].

²¹*Id.* at 62.

The crusade in which Seligman participated so eloquently was ultimately successful, and the property tax in the United States has become overwhelmingly a tax on real estate. Moreover, to the extent that personal property is taxed, specific exemptions for inventories, machinery, and manufacturing equipment are widely available.²² This simplifies tax administration, for personal property, unlike land and buildings, may have a tax situs in more than one jurisdiction over the course of a year.²³ For example, a 1989 Oregon case dealing with a property tax on aircraft held that the tax could be apportioned according to the time the aircraft spent in flight over the state, even without landing there.²⁴

Direct and Indirect Taxation of Intangibles

Taxes on intangibles as such now exist in only a minority of states.²⁵ Despite this, the valuation and taxation of intangibles raise urgent legal issues in many jurisdictions, primarily when assessed valuation of real property is increased by intangible factors, such as going-concern value. The valuation of many types of property reflects both tangible and intangible elements, not readily separated, and therefore intangible property may be taxed indirectly through its enhancement of the value of tangible property for assessment purposes. In addition, many railroads and utilities are subject to "unit valuation" by

²²Commerce Clearing House, 1990 *State Tax Guide*, paragraph 20-150 (business inventories completely exempt from tax in thirty-three states). See also S. Gold, "How the Taxation of Business Property Varies Among the States," 9 *Assessment Digest* 14 (1987).

²³See *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) (dealing with application of the commerce clause to the taxation of foreign-owned cargo shipping containers).

²⁴*Alaska Airlines, Inc. v. Department of Revenue*, 307 Or. 406, 769 P.2d 193 (1989), *cert. denied*, 493 U.S. 1019 (1990). Under this approach, a nonstop flight from Seattle to Los Angeles would serve to increase the apportionment factor, and therefore the total property tax, assessed in Oregon. The Oregon Supreme Court observed, "As might be expected, overflights involved little contact with ground facilities, and the State of Oregon did not provide regular services to overflights." However, because the aircraft was found to be part of a unit with a taxable situs in the state, and the apportionment formula was found to be fair, the tax was upheld.

²⁵A major 1990 study found "only 22 states or their subdivisions levy any tax on intangibles, *per se*." J. Bowman, G. Hoffer and M. Pratt, "Current Patterns and Trends in State and Local Intangibles Taxation," 43 *National Tax Journal* 439, 441 (1990). The policy advantages and drawbacks of intangibles taxation as such were debated in a set of *National Tax Journal* articles in 1964 and 1965: J. Blackburn, "Intangibles Taxes: A Neglected Revenue Source for States," 18 *National Tax Journal* 214 (1965) and J. Aronson, "Intangibles Taxes: A Wisely Neglected Revenue Source for States," 19 *National Tax Journal* 814 (1966).

which state officials assign a systemwide value to be allocated among local jurisdictions. This often includes a going-concern element over and above the value of tangible real estate and personal property.²⁶

The most common forms of intangible property subject to direct taxation are equities and bonds, but other specific intangibles are taxed in various states. For example, Georgia, Kentucky, and West Virginia impose a property tax on patents, copyrights, licenses, and franchise agreements.²⁷ Washington taxes software as an intangible, and Florida taxes private leaseholds on government property as intangibles.²⁸ The taxation of computer software illustrates the manner in which valuation of tangible property can serve to bring intangible values into the tax base. Most states classify noncustomized software as tangible property for tax purposes.²⁹ The valuation of custom-written software, however, presents a difficult question as to whether valuation at anything more than the price of the tangible materials constitutes the taxation of intangible property.³⁰ When this question is answered in the negative, a state has achieved the same result through its tangible property tax that Washington has achieved through the taxation of intangible property.

Such disputes far predated the development of commercial software. In *Michael Todd Co. v. County of Los Angeles*,³¹ the same question arose with regard to valuation of the copyrighted film negatives of the motion picture "Around the World in Eighty Days." The studio argued that they should be valued only on the basis of their physical material,

²⁶See A. Woolery, *Valuation of Railroad and Utility Property* (1992).

²⁷J. Bowman, G. Hoffer and M. Pratt, "Current Patterns and Trends in State and Local Intangibles Taxation," 43 *National Tax Journal* 439, 443 (1990); ACIR, *Significant Features of Fiscal Federalism* 1991, Vol. 1, Table 45.

²⁸J. Bowman, G. Hoffer and M. Pratt, "Current Patterns and Trends in State and Local Intangibles Taxation," 43 *National Tax Journal* 439, 445-446 (1990).

²⁹"States universally have held that 'canned' software and hardware are subject to sales tax. Only 16 states have found custom software to be subject to sales tax." Friedman and Taylor, "State and Local Taxation of Software," 7 *Computer Lawyer* 20, at n. 4 (1990). Disputes as to whether software constitutes tangible or intangible property arise with respect to sales tax statutes because those generally apply only upon the transfer of tangible property.

³⁰E.g., *Touche Ross & Co. v. State Board of Equalization*, 203 Cal. App. 3d 1057, 250 Cal. Rptr. 408 (1988) (software held to be tangible); *Northeast DataCom v. City of Wallingford*, 563 A.2d 688 (Conn. 1989) (software intangible, except for the physical medium); *District of Columbia v. Universal Computer Associates, Inc.*, 465 F.2d 615 (D.C. Cir. 1972) (software an intangible, upon similar facts); *Comptroller of the Treasury v. Equitable Trust Co.*, 296 Md. 459, 464 A.2d 248 (1983) (software tangible, upon similar facts).

³¹57 Cal.2d 684, 371 P.2d 340, 21 Cal. Rptr. 604 (1962).

and taxed at a nominal sum. The county sought to value them on the basis of the copyrighted information that they contained--a completed film production.³² The California Supreme Court upheld a valuation of over \$1.5 million, although the stipulated value of the negatives without the copyright was \$1,000.³³ This led to 1968 legislation in California limiting the taxation of motion pictures to the value of their tangible materials.³⁴

Although intangible property is often easier to conceal from assessment than real estate, when assessed it may be more readily assigned a market value. This disparity between the process of estimating a value for real estate and for financial assets was another factor contributing to the demise of the general property tax. In *Von Ruden v. Miller*,³⁵ a 1982 Kansas case upholding a tax on intangible property, the court explained the historical background to the 1924 state constitutional amendment exempting intangibles from the uniformity otherwise required in property taxation:

Prior to the amendment all property in the state, except that exempted by statute or the constitution, was required to be uniformly assessed at its fair market value in money and equally taxed within its taxing district. There was only one class of property for tax purposes. The assessing was accomplished by township trustees

³²Walt Disney Studios took the opposite position when it successfully sought an investment tax credit for its master negatives, a federal income tax benefit available only for tangible property:

In *Walt Disney Productions v. United States* [327 F. Supp. 189 (C.D. Cal. 1971), *modified*, 480 F.2d 66 (9th Cir. 1973), *cert. denied*, 415 U.S. 934 (1974)], the taxpayer, a producer of motion pictures, claimed that certain of its motion picture "master" negatives came within the statutory provisions describing section 38 property and therefore were eligible for the ITC. The negatives, it claimed, were standardized articles of tangible business capital used to produce the taxpayer's products, motion picture prints. Accordingly, the taxpayer had capitalized all the costs it had incurred in creating the master negatives - such as costs of labor, editing and film developing - into the value of the motion picture master negative. It sought to claim the aggregate basis in its motion picture negatives as an investment in "tangible personal property."

J. Pavluk, "Computer Software and Tax Policy," 84 *Columbia Law Review* 1992 (1984), at 2004-2005 [citations omitted].

³³See generally K. Ehrman and S. Flavin, *Taxing California Property*, § 4:04 (3d ed. 1989).

³⁴Calif. Rev. & Tax Code, Sec. 988. The *Michael Todd* case is discussed in Note, "Indirect Taxation of Motion Picture Copyright," 15 *Stanford Law Review* 372 (1963).

³⁵642 P.2d 91 (Kansas 1982).

and county clerks. They were untrained and tended to view fair market value as the lowest possible value they could get by with, particularly since the taxpayer was often a neighbor and the assessor had similar property. Intangibles presented a troublesome problem because money and evidence of debt had a stated value thus presenting no opportunity to lower values to the ridiculous levels placed on tangible property. The only remaining method to satisfy the constitutional mandate of uniform and equal [valuation] was to assess tangibles at comparable values to the stated values of intangibles. Even though the increased assessed valuation would in theory lower levies accordingly, this solution was unacceptable to property owners. They did not trust local authorities to put this theory into practice.³⁶

As in the case of personal property generally, this concern led to a separate classification of intangibles, removing them from the uniform property tax. The court in *Von Ruden* noted that because "intangibles are transitory and easy to hide, the tax was the subject of wholesale evasion.....[A] 1955 Citizens Advisory Commission Study found Kansas residents owned \$691,000,000 in common stocks while the assessed value of both stocks and bonds in Kansas that year was only \$39,000,000." Gradually a tax on the income from intangibles, such as cash and securities, came to replace a property tax on the intangibles themselves.

When the valuation of property for tax purposes includes any element of good will or going-concern value, these intangibles are brought within the tax base. In the simplest case, the distinction between property value and business value is clear. The rental value of a commercial site, not the business income of the enterprise occupying it, provides an index of property value. In numerous situations, however, the delineation of property value is nowhere near so clear-cut. A business renting premises under a percentage lease pays rent based on enterprise income. Whenever property has a particular utility to a business or enterprise, its value will reflect that utility and, indirectly, intangible business values as well. This problem arises in every form of taxation that prescribes differential treatment for tangible and intangible property. The federal income tax law, for example, permits no depreciation or amortization deductions for property without an ascertainable useful life, such as business goodwill.³⁷ This means that the purchase of an ongoing business requires allocation of the payment for income tax purposes, not only between depreciable buildings and nondepreciable land, but also between depreciable assets and goodwill.

Goodwill, such as reputation or consumer loyalty, is just one of a number of intangible assets that may be included in the purchase price for a business. Others include going-concern value, or the benefit of an established business operation, and public or

³⁶*Id.* at 95.

³⁷U.S. Treasury Reg. Sec. 1.167(a)-3 states, "An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation....No deduction for depreciation is allowable with respect to good will."

private licenses or franchises necessary or beneficial to conduct of the business. Even if it is agreed that the licenses or franchises have value in themselves over and above the value of the tangible business property, a question still remains: does assessment of specialized tangible property at its value to an owner with a license or franchise indirectly incorporate those intangible elements into the tax base?

In the California Supreme Court case of *Roehm v. County of Orange*,³⁸ the extremely influential jurist Roger Traynor³⁹ set a compromise pattern whereby intangible property excluded from the tax base could still influence the valuation of other taxable property. In that case, a liquor license was held to be intangible property, not subject to tax, but the court acknowledged that a rise in the valuation of taxable property as a result of issuance of the license would be permissible. This approach has been followed in many later California decisions.⁴⁰

Although the exemption of much personal property from direct taxation was an important reform, it further removed the property tax from a general tax on wealth. A true wealth tax would measure the value of all assets, not just real property. It would also consider the net value of a taxpayer's assets and liabilities, reducing total asset value to reflect obligations such as mortgage indebtedness. Owners of houses of identical value may differ in the value of their other assets, such as stocks, bonds, bank accounts and other types of personal property. Homes of identical market value do not even indicate equivalent housing wealth if one is owned outright and the other is subject to a substantial mortgage. The real property tax in this country is imposed on gross value, with no offset for debt, so these two homeowners could face equivalent tax bills. The link between taxable value and ability to pay has diminished correspondingly since colonial times. The taxation of intangibles also raises interesting issues of double taxation, as when both a mortgage debt and the real property securing it are subject to tax.

Note on Cable Television Networks and Property Taxation

The increasing economic importance of cable television property has raised many questions concerning the taxation of personal and intangible property. One recurring problem involves the characterization of "house drops," the components connecting individual residences to the main cables. If these are considered personal property belonging to the cable television companies they may be taxed as business property. However, if they are considered "fixtures" that have become incorporated into the

³⁸32 Cal.2d 280, 196 P.2d 550 (1948).

³⁹See, e.g., A. Kragen, "Chief Justice Traynor and the Law of Taxation," 35 *Hastings Law Journal* 801 (1984).

⁴⁰E.g., *Simplicity Pattern Co. v. State Board of Equalization*, 27 Cal. 3d 900, 615 P.2d 555, 167 Cal. Rptr. 366 (1980); *Michael Todd Co. v. County of Los Angeles*, 57 Cal. 2d 684, 371 P.2d 340, 21 Cal. Rptr. 604 (1962), *ITT World Communications, Inc. v. County of Santa Clara*, 101 Cal. App. 3d 246, 162 Cal. Rptr. 186 (1980).

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residential real property itself they can only be taxed through an increase in the value of the homeowner's property.⁴¹

Cable-television cases also illustrate the difficulty of separating the value of tangible property from the value of intangible business assets such as goodwill. This problem often arises when business property is valued by reference to the income that a purchaser could expect from it, because that income is generally the joint product of tangible and intangible factors. In response to growing litigation on this point, legislation was enacted in California in 1988 stating that intangible assets or rights in a cable television system were not subject to property taxation, but that the system's right to use public property "may be assessed and valued by assuming the presence of intangible assets or rights necessary to put the cable television possessory interest to beneficial or productive use in an operating cable television system."⁴²

The difficulty of applying such a standard was illustrated in a case the following year⁴³ in which the Post-Newsweek cable television network charged that an increase in its assessment from \$5.5 million to \$16.1 million reflected the inclusion of the value of its franchise in the assessment of its right to use public property. The assessor contended that the network's ability to charge a fee for cable access and to make a profit from its franchise were inseparable from the value of its possessory interest. Although the franchises were themselves exempt, the court found it permissible for the assessor to take into consideration "the presence of the intangible assets necessary to put the possessory interest to beneficial or productive use."

⁴¹In a representative dispute, the Michigan Supreme Court, after reviewing other cases in this area, held in *Continental Cablevision of Michigan, Inc. v. City of Roseville*, 425 N.W.2d 53, 430 Mich. 727 (1988), that house drops remain personal property taxable to the cable company. Other cases on this point include *Metrovision of Prince George's County, Inc. v. State Department of Assessments and Taxation*, 92 Md. App. 194, 607 A.2d 110 (1992), and *Tele-Vue Systems, Inc. v. County of Contra Costa*, 25 Cal.App.3d 340, 101 Cal. Rptr. 789 (1972) (portions of cable systems incorporated into realty owned by subscribers were improperly assessed to the cable system operators). A similar question is dealt with in the context of fire and security alarm systems in *Morse Signal Devices of California, Inc. v. County of Los Angeles*, 161 Cal.App.3d 570, 207 Cal.Rptr. 742 (1984), which found the systems taxable to the installer. For a general review of these and other questions relating to state and local property, sales and income taxation of cable television systems, see J. Gibbs, *State and Local Taxation Issues in Cable Television* (Practicing Law Institute No. G4-3845, 1990).

⁴²California Revenue and Taxation Code, §107.7(d).

⁴³*County of Stanislaus v. County of Stanislaus Assessment Appeals Board*, 213 Cal.App.3d 1445, 262 Cal.Rptr. 439 (1989).

Assessing and Collecting the Tax

The annual cycle of property taxation commonly begins with the assessors' computation of the total value of taxable property within the city, town or other taxing jurisdiction. The tax rate for the year is then set at a level designed to raise the amount required by the jurisdiction's budget, subject to state legislative and constitutional limitations on rates and considering funds available through fees, charges, non-property taxes, and intergovernmental grants. The property tax is sometimes termed a "residual" tax when its rate is determined by the revenue needed after accounting for other sources of local income. In the *Von Ruden* case discussed above, the court described the process in this way:

[A]d valorem tax levies are controlled by the program they fund. They are set by calculating the taxing unit's assessed valuation, adopting a budget, crediting carryover funds and state funds, then dividing the adjusted budgeted amount into the assessed valuation. The resulting quotient is the levy. This process is subject to the legislatively imposed limitation of budget and levies.⁴⁴

The tax rate is frequently expressed in "millage" terms. A mill is one-tenth of a percent, or one one-thousandth. For example, a tax rate of 11.5 mills per dollar of assessed value would produce a tax of \$11.50 on each \$1,000 of assessed value. This is equivalent to a tax rate of 1.15 per cent, which was approximately the nationwide average for single-family homes in 1987.⁴⁵

Local property taxes are administered by elected or appointed assessors subject to varying degrees of oversight by state agencies. The assessment of specific classes of property may be the responsibility of state officials, even if the resulting tax revenue accrues to local governments. Such property often includes railroad and public utility property assessed on a single state-wide basis and apportioned among local jurisdictions; it may also include industrial sites, manufacturing plants and mineral property.⁴⁶

<p>Assessed Value of Property Subject to Local General Property Taxation in 1986 After Deduction of Exemptions⁴⁷</p>
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⁴⁴642 P.2d at 99-100.

⁴⁵ACIR, *Significant Features of Fiscal Federalism* 1990, Vol. 1, Table 34 (data on FHA-insured single-family homes).

⁴⁶For example, in the *Alaska Airlines* case discussed above at note 23, the Oregon Department of Revenue, and not a local assessor, was responsible for valuation and apportionment of the airline property, and was therefore a party to that case.

⁴⁷Source: 1987 Census of Governments, Vol. 2, *Taxable Property Values*, Table

	Assessed Value (millions of dollars)	Percentage
Locally Assessed Property:		
Real Property	3,910,658	84.7%
Personal Property	466,253	10.1%
State Assessed Property	242,816	5.3%
Total	4,619,724	100.0%

Assessors in this country frequently do not bring any specialized academic background in property valuation and tax administration to their positions. Initial training, certification and continuing education courses are offered by professional organizations such as the International Association of Assessing Officers and by many state revenue agencies.⁴⁸ Requirements for training and certification vary widely among the states, as does the level of technical proficiency necessary to administer a property tax system. A thinly populated, homogeneous residential area might be served adequately by a local citizen willing to assume the position of town assessor. A major urban center requires staff and computer capacity sufficient to keep track of taxpayer identification, property records, sales and lease transactions, building costs and resale price levels, changes in property use, new construction, renovation and property loss, and eligibility for exemptions.

The most challenging aspect of assessment, assigning a value to each taxable parcel, has been revolutionized in recent decades by the development of computerized methods for predicting market values. Computer-assisted mass appraisal (CAMA) compares the characteristics of properties that have been recently sold with those of other properties that have not changed hands in order to estimate the market value of properties in this second group. The availability of data on large numbers of comparable properties permits the correlation of characteristics such as location, size, design and type of construction with selling price. This allows a market value based on these features to be projected for other properties that have not been sold. These methods do not necessarily

3, p.6. Sum of components differs from total due to rounding.

⁴⁸J. Malme, *Assessment Administration Practices in the U.S. and Canada* (Chicago: International Association of Assessing Officers, 1992, updated annually), provides a comprehensive summary of current approaches to tax administration issues of this type. Section 12 lists assessor training and certification programs by state and province.

require a large permanent assessment staff. State revenue departments sometimes provide computer support to small jurisdictions, and a number of commercial firms offer CAMA services on a contract basis.

It has occasionally been suggested that appointed assessors, insulated from political pressure, may value property more accurately than those who are elected. Although there is some supporting evidence from New York state, where there has been a long-term shift from election to appointment of town assessors, other empirical studies have found no difference in the accuracy of assessments on this basis.⁴⁹ This may be because appointment by elected officials is itself not a process divorced from political pressure.⁵⁰

Fractional Valuation and Classification

The amount of tax any given property owner must pay is the product of the assessed property value and the tax rate. There are several basic patterns that link these two elements of the assessment process. The law may call for a single uniform rate of tax levied on the full market value of the property. Alternately, it may prescribe a single uniform rate of tax on some specified fraction of full market value. For example, North Dakota statutes define the assessed value of taxable property as 50 per cent of its full and true value, and taxable value as a percentage (9 per cent for residential property, and 10 per cent for other property) of assessed value.⁵¹ In such a case the effective tax rate, or percentage of full market value represented by the tax, would be a corresponding percentage of the stated or nominal rate. Finally, the law may in either case call for a non-uniform system of taxation, with the effective tax rates differing according to property category, such as residential, commercial or industrial. Such classification may be achieved either through varying the fraction of full value on which the assessment is made, or through varying the tax rates according to category, or both.

Beyond these patterns of legal and explicit classification there exist many varieties of "extra-legal" classification, both deliberate and inadvertent, that vary the tax burden across property categories through inaccuracies in valuation. A failure to revalue property periodically will produce distortions in assessment as values rise in prosperous areas and fall in declining neighborhoods. If properties are revalued only when sales are

⁴⁹D. Gaskell, "More Towns Joining Trend Toward Appointed Assessors," New York State Board of Equalization and Assessment, *The Survey*, March-April 1988, p. 1; J. Bowman and J. Mikesell, "Assessment Uniformity: The Standard and Its Attainment," 9 *Property Tax Journal* 219 (1990).

⁵⁰For a comprehensive introduction to issues of property tax administration, see the compilation by the International Association of Assessing Officers, *Property Appraisal and Assessment Administration* (1990).

⁵¹J. Malme, *Assessment Administration Practices in the U.S. and Canada* (1992), Section 2, "Definition of Assessable Value."

recorded at the registry of deeds, parcels that once sold for similar amounts will continue to bear equivalent tax burdens as their market values later diverge. This illustrates the difference between the nominal tax rate, the rate prescribed by law, and the effective tax rate, the actual percentage of true market value represented by the tax bill. In this example, property owners who have suffered a loss in value will bear a heavier effective tax rate than the owners of appreciating property because their tax bills will constitute a higher percentage of their property's market value, even though the nominal tax rate is the same in each case.⁵²

This pattern may not be the result of simple inadvertence. Owners of property in prosperous neighborhoods may be more aware of property values and more likely to challenge an overassessment than other taxpayers. Moreover, the desire to benefit politically powerful groups has long motivated the relative over- and under-assessment of entire classes of property. In the past this resulted in specific instances of over-assessment of property owned by nonresidents in vacation areas, under-assessment of farm property, over-assessment of business property, and under-assessment of single-family residential property nearly everywhere. In this way the valuation of property for tax purposes actually becomes a part of the rate-setting process. A tax system with a single uniform nominal rate for all property can in fact impose many different effective rates if different parcels are assessed at varying percentages of full market value. If all assessments were at the same percentage of full value, each taxpayer would face the same effective rate, even though this might differ from the nominal rate. If, however, the values assigned to different properties represent different percentages of full market value, the taxpayers whose valuations reflect a lower percentage of full value will pay tax at a lower effective rate than will others whose properties are assessed on a higher fraction of full value. This is why *relative* over-assessment can be critical to the distribution of the tax burden. A taxpayer whose property is valued at half of its full market price will be unlikely to protest this mistake. But if in fact most property in the jurisdiction is valued at one-quarter of its full market price, that taxpayer is bearing a disproportionate share of the total burden. When entire categories of property are subject to systematic under- and over-valuation, as in the examples above, the tax system has been "classified" even if no legal enactment has prescribed different tax rates for different types of properties.

⁵²A 1980 study by the New York University Graduate School of Public Administration found that 1979 assessment ratios (assessed value as a percentage of full market value) for residential property alone in New York City varied from 22.3 per cent of market value for single-family houses to 68.3 per cent for newer elevator buildings. Effective tax rates, actual tax bills as a percentage of full market value, ranged from 2.15 per cent for one- and two-family houses to 5.19 per cent for other housing to 5.55 per cent for nonresidential property. Graduate School of Public Administration, New York University, *Real Property Tax Policy for New York City*, I-11, I-14 (1980).

Courts have in the past sometimes hesitated to overturn fractional assessment systems, reasoning that taxation on a uniform percentage of market value can in practice achieve the same results as full-value assessment, although with a higher nominal tax rate.⁵³ However, the assumption that all fractional assessments represent the same fraction of market value is almost never realistic. Moreover, failure to list a full value figure on the tax bill inhibits challenges to incorrect assessments. A taxpayer who knows that the assessed value he sees represents only a small part of his property's market value is rarely inclined to challenge the assessment. If, however, as described above, that assessment represents a higher percentage of full market value than assessments of other property in the jurisdiction, the taxpayer is overassessed. Yet in order to prove that this situation exists, the taxpayer must determine the average level of assessment in the jurisdiction. This could be a formidable task where the average level is the composite of many unrelated instances of varying degrees under-assessment. The expense and difficulty of proving jurisdiction-wide assessment levels has been an important impediment to taxpayer challenges in the past.⁵⁴

Legal attacks on such practices have been increasingly successful in recent years, aided by legislative and administrative moves toward full-value assessment. However, it has not been uncommon for successful legal efforts overturning illegal tax classification of property to be followed by successful counter-measures to amend state tax statutes to permit such classification, explicitly imposing lower rates on favored classes such as single-family residential property. In response to a legal decision which would have required uniform full-value assessment,⁵⁵ the New York legislature in 1981 prohibited New York City from raising assessments on one-, two- and three-family houses by more than 6 per cent a year. As a result, the rapid housing inflation of the 1980s left the disparity between the effective tax on favored and disfavored properties more dramatic than ever. A 1990 study by the New York State Comptroller echoed the New York University findings of a decade earlier, detailing "a distressing lack of uniformity within every property class and within almost every neighborhood in the city....[T]he less valuable the property, the more it is taxed in relation to its market value."⁵⁶

⁵³For a thorough examination of these developments, see the three-part article by Robert Beebe and Richard Sinnott, "In the Wake of Hellerstein: Whither New York?" in 43 *Albany Law Review* 203-293, 411-486, 777-860 (1979).

⁵⁴For example, in *Pellaton Apartments v. Board of Assessors*, 43 N.Y.2d 769, 372 N.E.2d, 401 N.Y.S.2d 1013 (1977), taxpayers who prevailed on the merits in challenging relative over-assessment then sought statutory recovery of their costs. They requested reimbursement of \$484,000, including \$281,000 for expert testimony on appraisal and statistics, and were awarded \$435,000.

⁵⁵*Hellerstein v. Assessor of Islip*, 37 N.Y.2d 1, 332 N.E.2d 279, 371 N.Y.S.2d 388 (1975).

⁵⁶A. Finder and R. Levine, "When Wealthy Pay Less Tax Than the Other Homeowners," *The New York Times*, May 29, 1990, A1, at B6. This study found that in 1988 and 1989 the average assessment error in the city was 43 per cent for one-family

A study by Jerome F. Heavey⁵⁷ demonstrated how inter-jurisdictional assessment disparities can replicate these intra-jurisdictional problems. He examined thirty-five Pennsylvania school districts whose boundaries included at least one city and one or more other local government units. For example, the Weston Area School District included the City of Weston, Wilson Township, Nether Township and Bucks Borough. As a separate taxing jurisdiction, the school district imposed its own property tax, but like all of the other units it used values computed by the county assessor. Although the law required uniform assessment levels throughout the county, there was widespread relative over-assessment in the core cities and under-assessment in the outlying areas. Like most states, Pennsylvania established an agency to sample and compare assessment levels in different localities. When state aid to localities depends in part on the local tax capacity, this "equalization" process is necessary to prevent assessment inaccuracies from distorting the distribution of funds.⁵⁸ Heavey used Equalization Board data to conclude that in fourteen of the thirty-five districts studied the excess taxes collected from the cities equaled or exceeded 10 per cent of the taxes collected by the cities for their own use. Five cities' annual school tax "overpayment" exceeded 20 per cent of their own tax revenue, and in one case it exceeded 30 per cent.

This example demonstrates one additional reason for the historical assessment of property at less than full market value. If all property within a taxing jurisdiction were assessed at the *same* percentage of full value, fractional assessment would have no necessary effect on tax liabilities. Nominal tax rates would rise, but effective rates, measured as a percentage of full market value, would remain unchanged. Prior discussion has focused on the incentives for non-uniform fractional assessment as a means of favoring one class of property over another. But even uniform fractional assessment provides an advantage if the valuations are to be used by another level of government imposing a tax on several jurisdictions, such as a school district in this example, or if state aid is to be distributed according to a formula based on local property values. Either of these two situations can give rise to competitive under-assessment.

houses. On a house valued at \$200,000, the owner should have paid \$1,153 in property taxes. But with a 43 per cent assessment error, there was an equal chance that the owner paid taxes as high as \$1,649 or as low as \$657. The average error was even worse for other types of properties. In 1988 and 1989, the annual tax on a walk-up apartment building worth \$300,000 could have been as little as \$982 or as much as \$6,100. *Id.*

⁵⁷J. Heavey, "Patterns of Property Tax Exploitation Produced by Infrequent Assessments," 42 *American Journal of Economics & Sociology* 441 (1983).

⁵⁸Equalization data can sometimes be used by taxpayers seeking to prove assessment levels in a jurisdiction; because it is not compiled for this purpose, legislation has occasionally restricted its admissibility in such cases. See, e.g., *Colt Industries, Inc. v. Finance Administrator*, 54 N.Y.2d 533, 430 N.E.2d 1290, 446 N.Y.S.2d 237 (1982), *appeal dismissed*, 459 U.S. 983 (1982); *Slewett & Farber v. Board of Assessors*, 80 A.D.2d 186, 438 N.Y.S.2d 544 (1981).

One common measure of inequality in assessment is the coefficient of dispersion. This is a measure of the amount by which assessments vary from the common level, that deviation expressed as a percentage of the common level. For example, consider a community where assessments are generally set at 30 per cent of market value. A taxpayer whose property is valued at 45 per cent of market value will not receive a tax bill that is 15 per cent too high. Rather, that bill will be 50 per cent higher than the correct amount. If the prevailing assessment ratio is 60 per cent, assessment at 75 per cent of market value will produce a bill that is 25 per cent higher than it would be if all assessments within the jurisdiction were uniform. Note that these examples deal only with inaccuracies in the valuation process, and assume that the correct tax rate is applied in each case. The coefficient of dispersion measures the proportionate error in the ultimate tax by calculating the amount by which assessments vary from the prevailing rate (the "dispersion") as a percentage of that rate. The 1980 New York study cited above described a coefficient of dispersion of 20 per cent as "a barely adequate assessment performance" for property subject to frequent sales, such as single-family housing. That study found less than one-half of one percent of all housing in New York City to be in a class with a coefficient under this level.⁵⁹

An explicit, legal system of tax classification differs significantly from the "extra-legal" practices due to assessor bias or inaccuracy in valuation. Consider, for example, a statute calling for two rates of tax, one rate for residential property and a second, higher rate for all other property, with both rates imposed on a full market value base. Given accurate valuations, this system produces uniform tax burdens on all properties in a given class. By contrast, a system in which property values are updated only when a parcel is sold yields an array of effective tax rates - in theory, potentially as many tax rates as parcels in the jurisdiction, each rate determined by the relationship of the individual property's current market value to its previous sale price.

Property Tax Relief Measures

In addition to a full exemption for various classes of religious, educational and charitable, and governmental⁶⁰ property, most states offer an array of partial exemptions and tax reductions to benefit taxpayers deemed needy, worthy or politically powerful, such as widows, veterans and homeowners. All states offer tax reduction programs for qualifying farmland whose value in agricultural use is less than its market value for development. Two of the most important other tax relief measures are "circuit breakers"

⁵⁹New York University Graduate School of Public Administration, *Real Property Tax Policy for New York City* I-17 (1980), discussed at note 52, above.

⁶⁰The federal government and its instrumentalities are immune from state and local taxation under the Supremacy Clause of the U.S. Constitution, Art. VI, §2, rather than exempted by any provision of state law. This doctrine was first enunciated in *McCulloch v. Maryland*, 17 U.S. 316 (1819), which overturned a Maryland tax on notes issued by the Bank of the United States.

and homestead exemptions. Circuit breakers limit property taxes to a designated percentage of income; as their name implies, they are designed to protect against a tax overload. They generally are administered and financed by the state through an income tax credit, although some are designed as independent programs. As in the case of other programs administered through income tax credits, special efforts are required to reach potential recipients who do not file income tax returns. The specific details of these programs vary widely among the states. Among the thirty-two states with circuit breaker programs in effect in 1991, the average benefit to homeowners ranged from \$55.06 in Hawaii to \$593.45 in Maryland.⁶¹

"Homestead" exemptions or credits are the most common form of residential property tax relief, utilized in some form by forty-four states in 1991.⁶² These reduce the tax on qualifying residential property, either by exempting a portion of its value or by extending a credit against the tax. Homestead exemptions may be limited to property owned by certain groups of taxpayers, such as low-income, elderly or disabled homeowners, or they may apply to all owner-occupied residences. Some states provide tax relief to renters as well, for example, through an income tax deduction. Although the revenue loss from circuit-breaker programs is generally borne by state governments, in the case of homestead allowances it usually falls on localities themselves. The cost of homestead relief programs in 1991 was estimated at \$451 million in Illinois, \$1.7 billion in Florida and \$3.3 billion in California.⁶³

Tax benefits limited to specific groups sometimes face constitutional objections. A 1974 decision by the Supreme Court found no equal protection⁶⁴ violation in a Florida statute allowing a \$500 property tax exemption to widows, but not to widowers.⁶⁵ Some exemptions are available only to state residents, and denied to nonresidents owning vacation property in the state. Provisions of this type have been upheld against attack under the Equal Protection Clause and the Privileges and Immunities⁶⁶ Clause of the U.S.

⁶¹ ACIR, *Significant Features of Fiscal Federalism* 1992, Volume 1, Table 41. See also R. Ebel and J. Ortbal, "Direct Residential Property Tax Relief," *Intergovernmental Perspective*, Spring 1989, p. 9.

⁶² ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 1, Table 40.

⁶³ ACIR, *Significant Features of Fiscal Federalism* 1992, Vol. 1, Table 42.

⁶⁴ U.S. Constitution, Amend. XIV, § 1, provides that no state shall "deny to any person within its jurisdiction the equal protection of the laws."

⁶⁵ *Kahn v. Shevin*, 416 U.S. 351 (1974).

⁶⁶ Article IV, §2, cl. 1 of the U.S. Constitution provides, "The Citizens of each State shall be entitled to all the Privileges and Immunities of Citizens in the several States." This "does not preclude disparity of treatment in the many situations where there are perfectly valid independent reasons for it....[But] it does bar discrimination against citizens of other States where there is no substantial reason for the discrimination beyond the mere fact that they are citizens of other States." *Toomer v. Witsell*, 334 U.S. 385, 396 (1948) (striking down South Carolina license fee for shrimp boats of \$2500 for non-

Constitution.⁶⁷ By contrast, the Supreme Court held in 1985 that a New Mexico property tax exemption limited to Vietnam veterans who resided in the state before May 8, 1976 violated the federal equal protection clause, failing to meet even the minimal standard of rational relationship to a legitimate state purpose.⁶⁸ The court held that a state "may not favor established residents over new residents based on the view that the State may take care of 'its own'....Newcomers, by establishing bona fide residence in the State, become the State's 'own' and may not be discriminated against....."⁶⁹

Tax relief measures must also satisfy the provisions found in nearly all state constitutions requiring uniformity in property taxation. In a typical dispute, the Idaho Supreme Court considered a homeowners' exemption passed by initiative in 1982 exempting the lesser of the first \$50,000 or 50% of the value of an owner-occupied residence. To maintain revenue, property tax rates rose by approximately one-third between 1982 and 1983, resulting in a significant increase in the tax burden on other properties. Owners of rental property in Bonneville County challenged this exemption as a violation of the state constitution's requirement that "every person or corporation shall pay a tax in proportion to the value of his, her, or its property," and that "[a]ll taxes shall be uniform on the same class of subjects within the territorial limits of the authority levying the tax." The decline in total taxable value caused by the exemption resulted in a rise in tax rates. The effect of the increased homeowners' exemption was illustrated by the following example, considering two properties of equivalent market value:

	<u>Assessed Value</u>	<u>Tax Liability</u>	
		<u>1982</u>	<u>1983</u>
Owner-Occupied Property	\$100,000	\$1,453	\$1,085
Other Property	\$100,000	\$1,615	\$2,170

residents and \$25 for residents.) The privileges and immunities of national, as opposed to state, citizenship are protected by the Fourteenth Amendment, § 1: "No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States..." However, the Supreme Court has interpreted this so narrowly as to render it nearly irrelevant to state and local taxation. See, e.g., *Colgate v. Harvey*, 296 U.S. 404 (1935) (the only case to strike down a state enactment under this section; overturned a state income tax limited to dividends and interest earned outside the state); *Madden v. Kentucky*, 309 U.S. 83 (1940) (overruling *Colgate v. Harvey*).

⁶⁷*Rubin v. Glaser*, 83 N.J. 299, 416 A.2d 382 (1980), *appeal dismissed*, 449 U.S. 977 (1980) and *Baker v. Matheson*, 607 P.2d 233 (Utah 1979).

⁶⁸*Hooper v. Bernalillo County Assessor*, 472 U.S. 612 (1985).

⁶⁹*Id.* at 613.

The Idaho Supreme Court found this result sanctioned by the state constitution's allowance for such exemptions from taxation "as shall seem necessary and just," rejecting the argument that this provision only permitted complete exemptions and not partial exemptions equivalent to disparate tax rates.⁷⁰

The exemption of property used for religious purposes raises important first amendment questions as to the ability of a state to question the legitimacy of any given religious sect. For example, a 1981 Minnesota case⁷¹ rejected both a religious exemption and a homestead exemption for the residence of a family whose eleven members formed the complete original congregation of the Ideal Life Church. Seven neighbors were added later. The Ideal Life Church had no doctrine, no belief in a supreme being, and no religious ceremonies except a monthly dinner.

That family had obtained a charter for fifty dollars from the Universal Life Church, an organization that figured in a more serious tax-avoidance scheme in New York state. More than 200 of the 236 full-time resident taxpayers in the town of Hardenburgh, in upstate Ulster County, including the town assessor, claimed a religious property tax exemption after obtaining Universal Life Church charters by mail. This left the property tax burden almost entirely on vacation property owned by non-residents. After eight years of litigation, the exemptions were overturned because the property was owned by individuals and not held in trust for members of a church. The New York Court of Appeals found this requirement a reasonable regulation and not an interference with or discrimination against any religious practice or belief.⁷²

The New York State Division of Equalization and Assessment undertakes a

⁷⁰*Simmons v. Idaho State Tax Commission*, 111 Idaho 343, 723 P.2d 887, 892-893 (Idaho 1986). For a comprehensive review of all state constitutional provisions on uniformity in property taxation, see W. Newhouse, *Constitutional Uniformity and Equality in Taxation* (2d ed. 1984).

⁷¹*Ideal Life Church of Lake Elmo v. County of Washington*, 304 N.W.2d 308 (Minn. 1981).

⁷²*Town of Hardenburgh v. State of New York*, 52 N.Y.2d 536, 421 N.E.2d 795, 439 N.Y.S.2d 303 (1981), *appeal dismissed*, 454 U.S. 958 (1981). The actual legitimacy of the religious charters was never litigated. The political problem of exemptions was greatly diminished by the transfer of five thousand acres of parkland from exempt organizations to the state, which pays local property tax upon it. "Tax Rebellion," *The New York Times*, March 13, 1983, page 49. For other cases on the tax status of non-traditional religions, see *Holy Spirit Association for the Unification of World Christianity v. Tax Commission*, 55 N.Y.2d 512, 450 N.Y.S.2d 292, 435 N.E.2d 662 (1982) (finding the Reverend Moon's Unification Church to be a religious rather than a political organization) and *Foundation of Human Understanding v. Department of Revenue*, 301 Or. 254, 722 P.2d 1 (1986).

comprehensive annual survey of exempt property in that state. This found that approximately 26 per cent of the market value of all real property in the state was exempt from taxation in 1990. In ten of the state's sixty-two cities at least half the total property value was exempt; the figure for New York City was 31 per cent.⁷³ Studies of this sort are not common, but in their absence there is no way to measure the cumulative economic impact of exemption measures.⁷⁴

Exempt organizations owning large amounts of property sometimes make voluntary payments in lieu of taxes to offset the cost of public services provided to them. Harvard University has described itself as the first non-profit institution to make such payments, having begun this practice in 1929. Its 1989 payments to the City of Cambridge totaled slightly under \$1 million, compared with taxes and fees on its non-exempt properties of \$4.5 million. Yale University began in-lieu payments to the city of New Haven in 1990 with an agreement to pay \$1.16 million for fire services, an amount approximately equivalent to 6 per cent of the city's annual fire department budget.⁷⁵ The federal government also sometimes provides voluntary payments in lieu of taxes to local

⁷³New York State Board of Equalization and Assessment, *Exemptions from Real Property Taxation in New York State* (1992). New York state law requires assessors to furnish a comprehensive annual listing of exempt property, and the State Board to publish an annual summary of exemptions. N.Y. Real Property Tax Law, §496. The New York exemption is analyzed in depth in P. Swords, *Charitable Real Property Tax Exemptions in New York State* (1981).

⁷⁴The 1987 Census of Governments provides estimates of the value excluded from the tax base by total exemptions in eighteen states, and by partial exemptions in thirty states, but notes that "it is unlikely that assessors devote more than minimal appraisal resources to valuing excluded property (since no tax revenue stems from the activity)...." 1987 Census of Governments, Vol. 2, *Taxable Property Values*, Tables J-K, at XX. A review of the background of the tax exemption for charitable property and a state-by-state summary of provisions relating to it may be found in W. Wellford and J. Gallagher, *Unfair Competition? The Challenge to Charitable Tax Exemption* (1988).

⁷⁵J. Barron, "Yale Will Pay \$2.6 Million to New Haven," *The New York Times*, April 3, 1990, page B1. In these situations university officials generally stress the voluntary nature of the payments and the services provided to the community by the university, such as maintenance of public roads on campus, while local officials point to the unreimbursed services received by the exempt institution and the reduction in the local tax base through exemptions. For example, this article reported that the University of Scranton makes in-lieu payments of \$120,000 annually to the city and county for fire services. It quoted the university president as saying, "It's voluntary....I think it's appropriate for us to do it, even though ultimately this has to come from tuition....We run a very close budget." The Scranton fire department superintendent replied, "I believe they should pay at least a million."

jurisdictions.⁷⁶

An exemption from property taxes generally does not carry an equivalent exemption from special assessments, which are imposed to cover the cost of public improvements, such as sidewalks or street lighting. Special assessments are often allocated among the benefited properties according to a physical measure, such as street frontage, rather than valuation. The distinction between a property tax and a special assessment has been considered in many cases.⁷⁷

Multi-use facilities owned by charitable or educational institutions are sometimes found to be partially exempt and partially taxable. For example, the public cafeteria or gymnasium in a YMCA could be treated as equivalent to a commercial restaurant or health club rather than as part of an exempt institution. Space for doctors' offices on hospital premises or in adjacent office buildings owned by the hospital has long been subject to disputes of this sort.⁷⁸

⁷⁶See generally ACIR, *Payments in Lieu of Taxes on Federal Real Property* (1981), which found "there is no guiding principle regarding the extent to which the federal government as a property owner should contribute to the financial support of state and local governments."

⁷⁷For example, *Zelinger v. City and County of Denver*, 724 P.2d 1356 (Colo. 1986), considered a charge for storm drainage facilities in the county of Denver. The charge rose with a parcel's ratio of "impervious" land, developed and therefore no longer absorbing rainfall, to "pervious" land. The court held that this charge was not a tax, and therefore need not comply with the uniformity provisions of the Colorado constitution. It was found to be a special assessment rather than a tax because it was directed only against users of the public improvement and all revenue raised by it was devoted to the maintenance, operation or development of the improvement.

⁷⁸*Little Falls Hospital v. Board of Assessors*, 348 N.Y.S.2d 856, 75 Misc.2d 731 (1973) found rental space for private medical practices taxable, as any office building would be. The lower court in *Genesee Hospital, Inc. v. Wagner*, 76 Misc.2d 281, 350 N.Y.S.2d 582 (1973), *rev'd*, 47 A.D.2d 37, 364 N.Y.S.2d 934 (1975), *aff'd*, 39 N.Y.2d 863, 352 N.E.2d 133, 386 N.Y.S.2d 216 (1976), took the opposite position, finding the doctors' office building to further the hospital's exempt purpose by making its Rochester location more attractive to doctors. The opinion stressed the bad weather and high taxes suffered by residents of upstate New York, but was nonetheless reversed on appeal. *Barnes Hospital v. Leggett*, 589 S.W.2d 241 (Mo. 1979), abandoned Missouri's all-or-nothing approach to the exemption, ordering an allocation of taxable value to the portions of a doctors' office building not used solely for nonprofit purposes. A dissenting opinion argued that such an allocation was impractical, pointing to difficulties in imposing a lien for unpaid taxes upon only a part of a building. This approach also raises many difficulties encountered in the valuation and assessment of taxes upon

Taxation of partial interests in exempt property is the rule rather than the exception when an exempt organization leases its property for commercial use. Even when the underlying full ownership interest cannot be taxed, the leasehold may be taxed, and may in fact be assigned a value equivalent to the full value of the property. This situation has arisen frequently with respect to federal government property leased to defense contractors. Although the federal interest is immune from state and local tax, the Supreme Court has held that a tax on the non-exempt use could be equivalent to the value of the property itself. The court found "no essential difference so far as constitutional tax immunity is concerned between taxing a person for using property he possesses and taxing him for possessing property he uses when in both instances he uses the property for his own private ends."⁷⁹ Where such a tax is imposed, the taxing jurisdiction has no ability to seize the underlying federal property as a means of enforcing payment of the tax on the leasehold. Nor may leased federal property be taxed if property leased from state or local governments is exempt.⁸⁰

A different issue arises in evaluating the desirability of tax reductions designed to promote construction and economic development. New York City has had a long and controversial history of granting abatements and partial exemptions for this purpose. In its fiscal crisis of the 1970s the city obtained state approval for exemptions of up to 95% of the first year's taxes due on new construction, a provision that benefited the AT&T, IBM and Philip Morris, Inc. headquarters, among other major projects. This caused an outcry in 1987 when AT&T, which had received \$42 million in tax reductions, announced plans to move its staff to New Jersey. The New York Times reported that even after AT&T agreed to limit these transfers "questions remained about whether the city should have gotten AT&T and some of the other beneficiaries of the tax break program to put job-related commitments on paper in the first place." Moreover, there was no means of ascertaining how much construction would have taken place absent these incentives. "The less a company needed something," said John Mollenkopf, a representative of the City Planning Commissioner, "the more likely they were to have high-priced talent arguing that they should get it."⁸¹

The Economics of the Property Tax: Incidence Analysis

Any evaluation of the political, legal and administrative aspects of the property tax is complicated by the fact that many questions concerning its economic effects remain unresolved. In particular, an active debate in recent years over the impact or incidence of the tax has attempted to clarify which parties actually bear its ultimate economic burden, a critical factor in considering the fairness, political merit,

partial interests generally.

⁷⁹*City of Detroit v. Murray Corp.*, 355 U.S. 489, at 493 (1958).

⁸⁰*U.S. v. City of Manassas*, 830 F.2d 530 (4th Cir. 1987), *aff'd*, 485 U.S. 1017 (1988).

⁸¹S. Verhovek, "Builders Got Tax Breaks, But What Did the City Receive?" *The New York Times*, May 24, 1987, page E6.

distributional consequences, or incentive effects of any tax measure.

Because the supply of land is fixed, it has long been accepted that a tax on bare land cannot be shifted forward from the landowner to the tenants. If the pre-tax rent was set at its most profitable level, the landowner is in theory powerless to recoup the tax through rent increases. This reasoning provided the impetus for the "single tax" movement of the nineteenth century. The populist reformer Henry George argued in his 1879 work *Progress and Poverty* that a confiscatory tax on bare land value could replace all other forms of taxation without affecting economic production. Moreover, he considered a confiscatory tax just, as rising land values were the results of social growth rather than the landowner's own efforts. A number of varied jurisdictions, including Jamaica, and districts in Australia and New Zealand, and the city of Pittsburgh, have experimented with variations on a site value tax, or tax on bare land value, including "graded" taxes that fall more heavily on land than on buildings.

Traditionally, a tax on buildings was analyzed differently from a tax on land, because the supply of buildings, unlike that of land, can be increased through new construction or decreased through a failure to maintain existing improvements. Therefore, in the long term the supply of building capital will respond to a tax by reducing the building stock, resulting in less construction and higher prices. Because any number of productive investments will compete for capital, this line of reasoning assumed that the burden of the property tax would be borne by users of property rather than suppliers of capital. In the case of business property, the potential for shifting the tax to suppliers or customers left the ultimate incidence uncertain. In the case of residential property, where this possibility did not exist, it was assumed that the long-run incidence of the tax was on the homeowner or renter. Studies of housing consumption have differed as to whether expenditures on housing remain proportional to income or form a lower percentage of income as income rises. The widespread belief that the percentage of income devoted to housing falls as income rises has supported the popular view that the residential property tax is regressive.

These assumptions concerning the incidence of a tax on building value have been questioned in the past two decades. The newer analysis has considered the property tax to consist of two elements: a basic rate equivalent to the tax common to all forms of wealth or capital, and the additional tax that would bring the rate to the actual amount paid by real property in a given jurisdiction. That second element could be in the form of a subsidy where actual property taxes were below the hypothetical common tax rate on capital. A tax on all wealth or capital would have incidence effects similar to those of a tax on bare land. To the extent the supply of capital was fixed, owners of capital would bear the economic burden of the tax. Under this approach only the second, variable tax could be avoided by withdrawing building stock from high-tax areas. The first component would remain in place whatever form the owner's investment might take. From this perspective, the uniform portion of the property tax may be viewed as part of a nationwide tax on capital. Because capital ownership generally increases with income, to

this extent the property tax would be progressive. The second element of the tax, which varies with the local rate, would be a selective tax on certain forms of capital, and therefore appropriately analyzed under the older view of property taxes.

These two approaches are not mutually exclusive. In some circumstances, a change in the property tax should clearly be analyzed as a local, selective measure. This would be the case if a specific jurisdiction were contemplating a change in its tax base or rate. On the other hand, nationwide property tax changes would be appropriate for consideration under the newer view of property taxes as in part a uniform tax on capital. Recent efforts to abolish residential property taxes in Ireland and Great Britain illustrate the type of dramatic legislative changes that require a broader economic perspective than was traditionally applied to this tax.

A further complication in determining the incidence of the property tax concerns the process of "capitalization," by which the imposition of a tax on durable property in fixed supply - such as land - reduces its price. A buyer comparing the purchase of real property and an alternative investment, identical in every other respect but not subject to the property tax, would judge the taxable realty to be worth less than the non-taxable investment, the reduction being equivalent to the present value of the annual real estate taxes. This suggests that the economic burden of a capitalized tax is borne by the owner holding the taxable asset at the time the tax was first imposed, because the tax did not reduce the price that owner paid but will reduce the price he receives in the future.

Consider the implications of yet another perspective on the property tax, one that views it as the equivalent of a fee for local services. This position has gained much attention in recent years, particularly because many services typically provided by local government lend themselves more readily to this analysis than do such federal functions as national defense and foreign relations. The Treasury Department study initiating the 1986 Tax Reform Act went so far as to contend that both state and local taxes are no more than "the cost paid by citizens for public services provided by State and local governments, such as public schools, roads, and police and fire protection," equating these with personal consumption expenditures.⁸² To the extent a property tax may be considered a charge for local government services it would not properly be analyzed as a "tax" at all. Questions of incidence and market distortion that are critical to understanding the economic operation of a tax on goods or services are largely inapplicable to an analysis of the price of those goods or services themselves.⁸³

⁸²*Treasury Report on Tax Simplification and Reform*, U.S. Treasury Department, Report to the President, November 27, 1984, Ch. 5, §IV(B)(1) ("To the extent that state and local taxes merely reflect the benefits of services provided to taxpayers, there is no more reason for a Federal subsidy for spending by state and local governments than for private spending.")

⁸³"If consumers choose residential locations based on the property tax and service package offered by the local government and if some mechanism arises to maintain the

The simplifications involved in all aspects of this description are evident. The relationships among income, wealth and property ownership are not well understood, and differ according to the time span over which they are measured. Taxes on capital generally are far from uniform, and the extent to which the property tax can be analyzed as consisting in part of such a uniform tax is uncertain. Neither the supply of capital nor even the supply of land is fixed in the long run for any specific jurisdiction. A city may annex neighboring land; farmland in one locality may become an office park or residential complex serving another urban center; even the physical supply of land may be increased through reclamation operations. It is important to recognize that many aspects of the economic impact of the property tax are not resolved, and that common generalizations as to its regressive nature may in fact not be supported by economic theory.⁸⁴

equilibrium, consumers who desire the same fiscal package are grouped together. The property tax is the 'price' for consuming local services, with all consumers paying the costs that their consumption imposes on the government. In that case, it does not make sense to separately discuss the incidence of the tax separate from the provision of public services because the tax simply reflects the demand for services." R. Fisher, *State and Local Public Finance* (1988) 156. "If consumers treat the local property tax as a price for public services, then this price should not distort the housing market any more than the price of eggs should distort the housing market." B. Hamilton, "Property Taxes and the Tiebout Hypothesis: Some Empirical Evidence," in *Fiscal Zoning and Land Use Controls, the Economic Issues*, E. Mills and W. Oates, eds. (1975), at 13, quoted in H. Rosen, *Public Finance* 488 (1st ed. 1985).

⁸⁴These issues are discussed in detail in "Property Tax: Economic Analysis and Effects," Chapter 8 in R. Fisher, *State and Local Public Finance* (1988), and treated more generally in many introductory public finance texts, including R. Musgrave and P. Musgrave, *Public Finance in Theory and Practice* (5th ed. 1989), H. Rosen, *Public Finance* (3d ed. 1992), and C. Shoup, *Public Finance*, Chapter 15 (1969). The basic technical articles in this area are C. Tiebout, "A Pure Theory of Local Expenditures," 64 *Journal of Political Economy* 416 (1956); P. Mieszkowski, "On the Theory of Tax Incidence," 75 *Journal of Political Economy* 250 (June, 1967); P. Mieszkowski, "The Property Tax: An Excise Tax or a Profits Tax?" 1 *Journal of Public Economics* 73 (April, 1972); P. Mieszkowski and G. Zodrow, "Taxation and the Tiebout Model: The Differential Effects of Head Taxes, Taxes on Land Rents, and Property Taxes," 27 *Journal of Economic Literature* 1098 (September, 1989). A less technical work, accessible to the non-economist, on the distinction between the "old" and "new" views of property tax incidence is H. Aaron, *Who Pays the Property Tax: A New View*, (Brookings Institution, 1975).