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Overview of House Bill 1 Income Tax and Property Tax Changes

The June 24th 2022 edition of *On The Money* provided an overview of changes to Ohio's state income tax from its inception in 1972 through the modifications made in June 2021 as part of the FY22-23 state budget bill. This edition of *On the Money* provides an overview of the main features of House Bill 1 (HB 1) which includes substantial changes to both Ohio's state income tax and to several provisions relating to Ohio's local property tax. The tax changes contained in HB 1 will have a profound impact not only on the state's taxpayers but also on the revenues of Ohio's schools and local governments.

1. Transformation to a Flat-Rate State Income Tax

HB 1 proposes an estimated $2 billion reduction in Ohio's state income tax. The income tax would be changed from the current graduated rate structure which has been in place since the income tax's inception in 1972 to a flat rate structure with a single rate of 2.75%.

The June 2022 issue of *On The Money* provides a detailed summary of the rates changes made to Ohio's income tax since 1972. Ohio expanded the number of rate brackets in the early years and increased rates from 1982-1984 before adding a new top rate bracket in 1993. Ohio then began a long series of income tax rate reductions in 2005. Table 1 shows Ohio income tax rates by income bracket in 1972, 1982, 1993 and 2019.

Table 1: Ohio State Income Tax Rates 1972, 1982, 1993, 2019

Original Taxable Income Range	1972-1981 Marginal Tax Rate	1982 Marginal Tax Rates	1993 Marginal Tax Rates	Taxable Income Range (these have been indexed for Inflation since 2012)	2019 Marginal Tax Rates	% Reduction 1993-2019
$0 - $5,000	0.5%	0.5%	0.743%	$0 - $10,850	**0.000%**	**100%**
$5,000 - $10,000	1.0%	1.0%	1.486%			
$10,000 - $15,000	2.0%	2.0%	2.972%	$10,851 - $16,300	**0.000%**	**100%**
$15,000 - $20,000	2.5%	2.5%	3.715%	$16,300 - $22,150	**0.000%**	**100%**
$20,000 - $40,000	3.0%	3.0%	4.457%	$22,151 - $25,000	**2.850%**	**-36.0%**
				$25,001 - $44,250	**2.850%**	**-36.0%**
$40,000 - $80,000	3.5%	3.5%	5.201%	$44,250 - $88,450	**3.326%**	**-36.0%**
$80,000 - $100,000		**4.0%**	5.943%	$88,450 - $110,650	**3.802%**	**-36.0%**
$100,000 - $200,000		**5.0%**	6.900%	$110,650 - $221,300	**4.413%**	**-36.0%**
Income > $200,000			**7.500%**	More than $221,300	**4.797%**	**-36.0%**

The data in Table 1 show that the income tax reductions made from 2005 through 2019 decreased rates by a cumulative “across the board” reduction of -36.0%. This means that when income taxes were reduced each of the rate brackets experienced the same percentage reduction in the marginal tax rate, with this cumulative reduction totaling minus 36.0%. This approach preserved the graduated nature of Ohio’s income tax that had been in place since 1993 1993. In addition, by “zeroing out” income taxes for individuals at lower incomes (all these with an income below $22,50 in 2019, the lowest rate brackets received a 100% reduction in their Ohio income taxes. This changed actually improved the relative equity of Ohio’s income tax by eliminating income taxes entirely for Ohio’s lowest income persons.

This proportional approach to cutting Ohio’s income tax (for those with incomes high enough that they still paid Ohio’s income tax) came to an end in 2021, however. HB 110, the FY22-23 state budget bill, included an income tax reduction that was initially described as a 3% reduction in Ohio’s income tax rates. However, HB 110 actually resulted in 3% reduction in tax rates for persons with an income between $25,001 and $110,650, a 9.6% reduction for persons with income between $110,651 and $221,300 and a 16.8% reduction in taxes for persons with incomes greater than $221,300.

While HB 110 made a modest move to flattening Ohio’s state income tax by eliminating the top income bracket in individuals with incomes greater than $221,300, HB1 implements the flat completely at a rate of 2.75% for all persons with incomes greater than $26,050. Table 2 compares Ohio income tax rates in 2019, 2021 and under HJB 1.

Table 2: Ohio Individual Income Tax Rates for 2019 and 2021/2022

Ohio Taxable Income 2021*	HB 166 Enacted 2019 Marginal Tax Rates	HB 110 Enacted Marginal Tax Rates 2021	HB 110 % Reduction vs HB 166 Rates	HB 1 Proposed Rates	HB 1 % Reduction vs. HB 110 Rates
$0 - $10,850	0.000%	0.000%			
$10,851 - $16,300	0.000%	0.000%			
$16,300 - $22,150	0.000%	0.000%			
$22,151 - $25,000	2.850%	0.000%	100%	0.00%**	
$25,001 - $44,250	2.850%	2.765%	3.0%	2.75%	-0.54%
$44,250 - $88,450	3.326%	3.226%	3.0%	2.75%	-14.8%
$88,450 - $110,650	3.802%	3.688%	3.0%	2.75%	-25.4%
$110,650 - $221,300	4.413%	3.990%	9.6%	2.75%	-31.1%
More than $221,300	4.797%	3.990%	16.8%	2.75%	-31.1%

* Note that the actual 2019 rate bracket income ranges were slightly different than those shown in Column 1 because inflation indexing was applied in 2020.

** 2.75% flat tax rate proposed in HB 1 actually will begin at an income level of $26,050 after indexing for inflation.

The figures in Table 2 show that the impact of incorporating a 2.75% flat rate income tax in Ohio is to give individuals earning more than $110,650 a 31.1% reduction in their marginal tax rate, individuals earning between $88,450 and $110,650 a 25.4% reduction, individuals earning between $44,250 and $88,450 a 14.8% reduction, and those earning above between $26,051 and $44,250 a reduction of just over ½ percent.

The percentage rate reductions shown for HB 1 in Table also provide some insight into the cost of moving to a flat rate income tax in Ohio. The estimated cost of the HB 110 rate reductions was just over $800 million annually. It is plain to see from looking at Table 2 that the reduction in income tax revenue will be more than double that amount as the percentage reductions in tax rates under HB 1 are much larger than those in HB 110. In this regard, the estimates of a $2 billion cost to move to a 2.75% flat rate income tax are entirely reasonable. The precise cost of the HB 1 income tax cut should be clarified once LSC releases the fiscal note on the bill in the next week or two.

One final implication of the Hb 1 change to the income tax cut is that the estimated $2 billion reduction in state income tax revenues will also mean that the Local Government Find (LGF) and Public Library Fund (PLF) will also bring a reduced amount of revenue. The LGF and PLF are long-standing revenue sharing programs which distribute state revenue to libraries, counties, townships cities and other local government units in Ohio. Governor DeWine's FY24-25 Executive Budget proposed increasing the LGF and PLF percentage rates to 1.7% of total state General Revenue Fund (GRF) tax revenues from their current statutory levels of 1.66. ***A reduction in GRF tax revenues of $2 billion would mean that both the LGF and PLF stand to lose $34 million in revenue annually.***

2. Changes to Ohio's Property Tax in HB 1

In addition to transforming Ohio's income tax from a graduated rate structure to a flat tax, HB 1 also makes a series of changes to Ohio's property tax. The LSC HB 1 Bill Analysis provides a basic description of the main features of the legislation as it impacts Ohio's property tax. The LSC summary can be found at:
https://www.legislature.ohio.gov/download?key=20450&format=pdf

While the main features of the property tax changes are relatively easy to explain, the ultimate impact is quite complicated in terms of the impact on both property taxpayers and on Ohio's schools and local governments. What follows below is an initial analysis of HB 1's property tax changes based on the information currently available.

A) Elimination of the 10% Rollback on Residential and Agricultural Property Taxes

HB 1 proposes the elimination of the property tax relief program commonly referred to as the "10% rollback" on residential and agricultural property. The 10% rollback, which was instituted in 1972 at the same time that the state income tax was created, means that the state pays to Ohio's schools and local governments 1/10th of the property taxes owed by residential and agricultural taxpayers. Inn 2022 the cost of the 10% rollback to the state was $1.221 billion with $805 million of the rollback total for taxes paid to K-12 school districts and JVSDs and the remaining $416 million split cross Ohio's municipalities, townships, counties, libraries and other local government agencies with levy authority, including children's services, elderly services, development disability, and alcohol, drug and mental health agencies. The most likely reason for the state to eliminate the 10% rollback is that the $1.221 reduction in state expenditures will help fill the budget hole created by the $2 billion in foregone tax revenue created by the flattening of the state income tax. ***However, elimination of the 10% rollback will mean that local property taxpayers, instead of the state, will now pay these taxes.***

B. Reduction in the Assessment Percentage on Residential & Agricultural Property from 35% to 31.5%

In order to offset the automatic increase in every residential and agricultural taxpayer's property taxes by the amount of their now-eliminated 10% rollback, HB 1 next includes a provision which reduces the assessment percentage on residential agricultural property from 35% to 31.5% (a 10% decrease). In Ohio the taxable value also known as the "assessed value") of real property (land and buildings) is only 35% of the value placed on real property by each of the 88 county auditors. This percentage has been 35% since the early 1970s and applies to both residential and agricultural property (known as "Class I" property) as well as business and commercial property (known as "Class II property).

Reducing the assessment percentage from 35% to 31.5% on residential and agricultural property is intended to offset the elimination of the 10% rollback by reducing the amount of taxes owed by residential and agricultural taxpayers. This occurs because the taxable value of property is now lower so these taxpayers will owe less on all "fixed rate" property tax levies in place across the state. School operating and permanent improvement levies as well as operating and permanent improvement levies placed on the ballot by non-school local governments that were approved by the voters for a specific millage amount, are considered to be fixed rate levies. Bond levies and school emergency and substitute levies are referred to as "fixed sum" levies because voters approve a specific dollar amount rather than a specific tax rate for these levies.

Reducing the taxable value of residential and agricultural property by lowering the assessment percentage to 31.5% will reduce the amount of taxes owed on fixed rate levies because the millage rate in place is now multiplied by a lower property valuation than when the assessment rate was 35%. "Inside mills" (the 10 mills of "unvoted" property taxation delineated in Article XII Section 2 of the Ohio Constitution) also function as fixed rate levies. However, bond, emergency and substitute levies will have their millage rate automatically adjust upward in order to continue to raise the voted dollar amount despite the decrease in that taxable value of property.

The result is that schools and local governments with no bond or emergency levies stand to lose 10% of the property tax revenue from residential and agricultural property as result of the decrease in the assessment percentage. This will severely compromise their ability to continue to provide the same level of local services as they do currently. Local governments with a bond levy or schools with an emergency or bond levy will have that tax revenue remain constant, however, the taxpayers in these localities will experience a tax increase as a result.

C) Reduction in the Assessment Percentage on Business & Commercial Property from 35% to 31.5%

While the intention of HB 1 seems to be to reduce the assessment percentage to 31.5% on residential and agricultural property in an attempt to offset the automatic increase in property taxes, which is the consequence of eliminating the 10% rollback, the legislation will almost certainly also result in a similar decrease in the assessment percentage on business and commercial property. The reason for this is a series of legal cases in the 1960s established that the assessment percentage on real property had to be the same across the state. Prior to the 1960s court rulings, it was common practice for county auditors to establish the taxable value of business and commercial property at a higher rate (typically 40-50%) than for residential and agricultural property (which was typically at 30%). As result, in the mid-1970s the Ohio legislature set a uniform assessment rate of 35% for all real property across the state. This 35% rate remains in place today.

As a result, HB 1's lowering of the assessment percentage on residential and agricultural property to 31.5% also requires that the assessment percentage on business and commercial property also be lowered from 35% to 31.5%. This reduction in the assessment percentage on business and commercial property will work in the exact same way as for residential and agricultural property, with property taxes decreasing on fixed rate levies and property tax rates increasing on fixed sum levies. One significant difference, however, is that the 10% rollback on business and commercial property was eliminated in 2005 as part of HB 66, legislation (which also eliminated the business tangible personal property tax). As a result, HB 1's reduction in the assessment percentage on business and commercial property will result in a clear tax decrease for business taxpayers (and accompanying loss of revenue for schools and local governments).

D) A Complication - the Role of House Bill 920

As if the preceding 2 pages of this article were not complicated enough, the impact of HB 1 is clouded by the presence of the property tax limitation commonly known in Ohio as HB 920. In 1976, after the setting of the 35% assessment percentage and following very rapid inflation in home prices, Ohio enacted HB 920, one of the most stringent property tax limitations in the country. The goal of HB 920 was to insulate homeowners from the effects of inflationary increases in their property taxes. The mechanism that HB 920 chose to implement to accomplish this goal was that of "tax reduction factors," which were reductions in voted property tax rates designed to adjust the tax rate downward when property increased in value after property reappraisal. The idea is that if property values are reappraised at 10% higher, the property tax rates on fixed rate levies (explained above) would be adjusted downward by just enough so that no additional revenue was generated from these levies. These adjusted tax rates are referred to as "effective millage rates." The HB 920 tax reduction factors are applied separately in each of Ohio's 4,000+ taxing districts. Furthermore, as a result of change made to the Ohio Constitution in 1980, the HB 920 tax reduction factors are applied separately to residential and agricultural property from business and commercial property.

For the purposes here, it is imperative to understand that while HB 920 was created in an environment of rapidly rising property values, the provisions of HB 920 also work in reverse. If property values after reappraisal are lower than they were previously then the HB 920 reduction factors will actually increase in order to ensure that property tax revenue from fixed rate levies does not decline.

The above discussion of the functioning of HB 920 is pertinent to the property tax provisions of HB 1 prompting the fundamentally important question:

> *Will the reduction in the assessment percentage from 35% to 31.5% automatically trigger HB 920 to adjust property tax rates upward in order to make sure that fixed rate levies generate the same amount of tax revenue at 31.5% as they did at 35%?*

From one perspective, the reduction in the assessment percentage is functionally similar to the reduction in property values that would occur if there was deflation and properties were reappraised at a value lower than they were earlier. (While property values are historically very stable and tend to move upward, the 2008-2009 recession did result in property value decreases.) From this perspective then HB 920 would automatically increase effective tax rates so that there was no revenue loss to schools and local governments. ***Thus, if HB 920 does apply, then residential and agricultural taxpayers would experience the very same increase in taxes (from the elimination of the 10% rollback) that the reduction in the assessment percentage to 31.5% was intended to prevent.*** In this case, business and commercial property taxpayers would also be in essentially the same position as they were prior to HB 1. The one exception is that the amount of revenue schools and local governments receive from inside millage will decrease as HB 920 cannot adjust inside millage upward.

The alternate perspective is that while the mathematical effect of lowering the assessment percentage is the exact same as if each county auditor reappraised property values 10% lower, the changing of the assessment percentage is a different thing than property reappraisal. If this perspective is taken, then the elimination of the 10% rollback and the reduction in the assessment percentage from 35% to 31.5% on both residential and agricultural as well as business and commercial property will have the effects outlined in sections 2, 3 and 4 above.

Once the implications are clear regarding whether or not the HB 920 reduction factor mechanism will be triggered by the reduction in the assessment percentage to 31.5%, the question becomes one of which of the two perspectives is correct?

Two lines of reasoning strongly suggest that the HB 920 tax reduction factors mechanism should in fact be triggered by HB 1's decrease in the Class 1 and Class assessment percentages to 31.5%.

First, the actual wording relating to the HB 920 property tax provisions that is contained in Article XII, Section 2a of the Ohio constitution indicates that the amount of taxes charged in the current year be set equal to the amount of taxes charged in the preceding year. The constitutional language does not make any mention of valuation, nor does it allow for an alteration to adjust for taxes collected in the event the assessment percentage is changed. This wording appears to clearly articulate that the HB 920 mechanism should activate to adjust taxes upward to assure that taxes in the year when property is assessed at 31.5% be set equal to the taxes charged in the preceding year when property was assessed at 35%.

Secondly, Ohio's recent experience changing the Current Agricultural Use Valuation (CAUV) formula is also instructive. The CAUV formula provides an alternate method for establishing the market value of agricultural property. Since the market value of such property can be influenced by its potential value as a shopping mall or residential subdivision the CAUV formula provides a method for valuing the land based on its value in agricultural use. The CAUV formula was modified several years ago after a number of years of sharply rising CAUV values.

The new CAUV formula, which is being phased in over a six-year timeframe, has resulted in a year-by-year reduction in agricultural property values. While the CAUV formula calculations are made by the Ohio Department of Taxation every year, they are implemented in each county at the time they go through reappraisal or statistical update. The new CAUV values are included in the residential and agricultural property tax duplicate in each taxing district alongside any changes (up or down) that might be occurring with residential property values. Once the new total valuation is reached, the HB 920 tax reduction factors are then implemented, and property tax rates get adjusted up and down depending on the overall change in total residential and agricultural values in each taxing district.

The implications of the CAUV formula change on the HB 1 property tax changes should be evident. A policy change in how agricultural property values are established was incorporated within the framework of HB 920 just as if the changes had occurred through the reappraisal process. This would seem to establish a clear parallel for how a policy change such as reducing the assessment percentage would be handled as well.

<u>Conclusions</u>

The property tax changes proposed in HB 1 revolve around 3 main components:

- The elimination of the 10% rollback and with it the $1.221 billion in property tax payments currently made by the state to schools and local governments.
- The reduction in the assessment percentage on Class 1 and Class 2 real property from 35% to 31.5%
- The question of whether the reduction in the assessment percentage will trigger Hb 920 to increase tax rates in order to offset the potential decrease in tax revenue.

While the ultimate impact of eliminating the 10% rollback and lowering the assessment percentage from 35% to 31.5% depends on whether or not HB 920 will apply, ***there are only two possible outcomes;***

1) <u>HB 920 does not apply</u> and schools and local governments will lose local revenue for all inside millage and fixed rate levies, compromising their ability to provide local services, or

2) <u>HB 920 does apply</u> and property taxpayers will experience an increase in taxes that will be roughly the same as that which would have occurred as a result of the elimination of the 10% rollback and which the reduction in the assessment percentage is trying to forestall.

Furthermore, from the standpoint of libraries and the other local governments who benefit from the Local Government Fund, ***the potential loss of local tax revenue from HB 1 is further compounded by the loss of $34 million in PLF and LGF revenue*** due to the $2 billion reduction in state revenue deriving from the flattening of the state income tax.