

State Notes

TOPICS OF LEGISLATIVE INTEREST

November/December 2006



Principal Residence Exemption Compliance Program **By Stephanie Yu, Fiscal Analyst**

The principal residence exemption was created by Public Act (PA) 237 of 1994.¹⁾ The exemption was part of a larger school finance reform package passed in 1994 to address accelerating property taxes and an increasing discrepancy in per-pupil spending across communities. In order to ease high property taxes for homeowners, the package created the homestead exemption and capped the rate at which assessed property values could increase. It may be claimed by a taxpayer on one property, and exempts that taxpayer from having to pay the 18.0-mill local school property tax. Owners of multiple residences may claim only one exemption on the domicile that is their principal residence. Due to the nature of the exemption, it is necessary to compare data across jurisdictions to identify taxpayers who, knowingly or unknowingly, claim the exemption improperly. Efforts to accomplish this are discussed below.

History

Since the exemption was introduced in 1994, the Department of Treasury has tracked claimed exemptions through a database. Local units receive affidavits filed by the homeowners claiming the exemptions, and the affidavits are passed on to the Department. While the Department does maintain a central database, that system is inadequate. Information is often incomplete, missing taxpayer or property information, or the affidavits might contain more than one property. Additionally, rescissions might not always be filed when individuals sell their residence, which results in the attachment of multiple exemptions to one property. Another major problem with the State database is that its match function is relatively unsophisticated; for example, it is unable to account for minor differences in information, such as taxpayers' middle initials, or changes to the prefixes or suffixes of parcel numbers, or the division of the parcels themselves or other changes to them. As a result, rescissions that are filed may not invalidate the original exemptions.

Public Acts 105 and 114 of 2003 amended the principal residence exemption compliance program, allowing counties to audit homestead exemptions and obligating the State to perform audits in any counties that elected not to perform them. In cases in which the exemption is erroneously claimed, the county or local government may collect taxes due as well as interest and penalties. In 2003, the Department of Treasury estimated that it would collect total revenue, including taxes, penalties and interest, of \$61.0 million in fiscal year (FY) 2003-04, \$32.3 million in FY 2004-05, and \$21.5 million each year after FY 2004-05. Revenue from the taxes goes to local school districts, reducing School Aid Fund expenditures, while interest and penalties are shared among county, local, and State governments. The unit performing the audit receives the majority of funds collected in interest and penalties. Sixty-one of the State's 83 counties opted to perform their own audits, while the remaining 22 chose to have the Department perform them. For the counties that

¹ Originally called the "homestead" exemption, it is now referred to as the "principal residence" exemption, as a result of legislation enacted in 2003 to avoid confusion with the homestead credit against property taxes.

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chose to perform the audits themselves, Treasury provided a list from its database, identifying potentially problematic exemptions.

In order to fund the State's costs related to counties that chose not to perform the audits, PA 161 of 2003, the general government appropriations act for FY 2003-04, included the following language:

Sec. 925. (1) In addition to the funds appropriated in part 1, the department of treasury may receive and expend homestead property tax exemption audit fund revenue for administration of homestead property tax exemption audits consistent with the provisions of Enrolled Senate Bill No. 520 of the 92nd Legislature.

(2) The department of treasury shall submit a report for the immediately preceding fiscal year to the state budget director and the senate and house fiscal agencies not later than December 31, stating the amount of revenue appropriated for homestead property tax exemption audits under subsection (1).

The language was included again in PA 327 of 2004, the general government appropriations act for FY 2004-05. The Legislature did not appropriate funds for the program in either FY 2003-04 or FY 2004-05.

To comply with this program, the Department engaged in two separate functions: issuing lists of leads to those counties that opted to perform their own audits, and auditing the remaining counties. The leads lists were culled from problematic exemptions, such as property with more than one exemption listed, or exemptions for which the billing address did not match the address of the principal residence. When the counties received the lists, they then could choose to take further action. The Department has no ability to track what the counties subsequently do. For those counties that chose not to perform their own audits, the Department created similar lists, compared income tax rolls with the addresses in the database, and issued approximately 69,000 letters to taxpayers, requesting further proof of their eligibility for the exemption. The Department received many complaints about this method, but ultimately issued 3,000 denials of these exemptions. The local units then needed to update their tax rolls to reflect the changes, but the Department has no means to enforce this.

In FY 2003-04 and 2004-05, legislative transfers were required to cover State costs for this program in the amounts of \$600,000 and \$500,000, respectively. It is estimated that the State received interest payments totaling \$50,000 in FY 2003-04 and \$80,000 in FY 2004-05.

In FY 2005-06, the principal residence exemption compliance program was rolled into the line item for the revenue enhancement program (which was appropriated \$6,590,000), and \$750,000 was earmarked for the audits. The language in PA 146 of 2005 reads as follows:

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Sec. 947. (3) The \$750,000.00 balance of the \$6,590,000.00 shall be used for the principal residence exemption compliance program. By November 1, 2005, the department of treasury shall submit a detailed spending plan regarding expenditure of the \$750,000.00. The plan shall include improvements to the current program administered by the department pursuant to PA 105 of 2003, and projected collections related to program improvements. The department shall also submit quarterly progress reports that detail the number of audits, number of exemptions denied, and the distribution of revenue received. The legislative auditor general shall complete a performance audit of the principal residence exemption compliance program prior to April 1, 2006. Revenue generated to the state from principal residence audits conducted under the principal residence exemption compliance program shall be used to reimburse the state general fund for the \$750,000.00 appropriation prior to any other allocation.

As of the end of January 2006, the Department had submitted a spending plan for the Principal Residence Exemption Compliance Program indicating that \$500,000 would be spent on a private contract to conduct the audits, \$200,000 on administration, and \$50,000 on information technology. Pursuant to that plan, the Department issued a Request for Proposal in January of 2006 to select a vendor for the program. However, by the February 15, 2006, deadline, the Request for Proposal generated only two responses, neither of which met the criteria established by the Department of Treasury. The Auditor General's office has indicated that it will not be able to perform the scheduled audit of the program as it is not yet in place. The recommended budget for FY 2006-07 includes a reduction of \$250,000 for the Principal Residence Exemption Compliance Program, leaving \$500,000 in the appropriation. The Department re-bid the contract in the summer of 2006 and accepted a bid from Tax Management Associates (TMA) to audit the 30 counties that will not perform their own audits in 2006 and 2007. As of December 2006, TMA had begun gathering data and expected to begin audit work in January 2007.

Revenue Generation

As mentioned above, local school districts retain any taxes collected, while the interest and penalties are distributed among the county, local, and State governments. Counties were given the choice to conduct their own audits or to allow the State to do the audits. If the counties perform the audits, they receive a larger percentage of the interest collected, whereas if the State has the responsibility, it retains a larger portion of that interest. The majority of counties chose to handle the audits themselves, some with help from the State. Because the counties are responsible for distributing any revenue generated, it is difficult for the State to track what has been collected. Revenue for local school districts reduces School Aid Fund spending, but cannot be traced to the program. Additionally, amendments to the statute allow counties to grant retroactive exemptions, which may be offsetting a portion of the revenue generated.

Since the State was unable to establish a contract to perform these audits until the end of the FY 2005-06 (September 15, 2006), it is unknown what portion of the appropriated \$750,000



has been spent. The Department has indicated that it is unlikely all of these funds would be spent during FY 2005-06.

Statewide Database

During Senate budget hearings on the FY 2006-07 budget bill, the Appropriations Subcommittee on General Government heard testimony from a variety of local officials on the Principal Residence Exemption Compliance Program. The testimony varied greatly regarding the revenue potential of the program. A representative from St. Joseph County indicated that in her preliminary analysis, there were many improper exemptions. The treasurer from Ingham County testified that the number of illegal exemptions in that county was relatively low and their denial probably would not generate significant tax revenue. While the testimony regarding the potential for revenue varied, the local officials agreed that a statewide database would make the enforcement of the program much simpler, and that the information that the Department of Treasury was providing was outdated. Following this testimony and discussions with the Department, the Legislature included the following language in PA 345 of 2006, the FY 2006-07 appropriation act for general government:

Sec. 947. (3) The \$500,000.00 balance of the \$5,856,800.00 shall be used for the principal residence exemption compliance program. Along with other program costs, expenditures shall include the development of a statewide web-based database created for the purpose of enforcing the principal residence exemption compliance program. The department shall submit quarterly progress reports that include the number of exemptions denied and the revenue received under this program. The legislative auditor general shall complete a performance audit of the principal residence exemption compliance program prior to April 1, 2007. Revenue generated to the state from the principal residence exemption compliance program shall be used to reimburse the state general fund for the \$500,000.00 appropriation prior to any other allocation. Additional funds from the revenue enhancement program and carryforward appropriations may be used to support costs in excess of \$500,000.00.

Language added to the Act also designates revenue enhancement funds as a work project, allowing unspent funds to be carried forward and used to support the program in subsequent years. It is expected that the database will require considerable time to create, and ongoing resources to maintain. Any remaining funds from the \$750,000 appropriated in FY 2005-06 also may be used for the database and the TMA contract.