Property Tax Systems in the United States:

The Tax Base, Exemptions, Incentives, and Relief

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Introduction

The general property tax in the United States is often viewed as a system in which all property is valued uniformly and taxed at a uniform rate in each taxing jurisdiction. Local governments in all 50 states and the District of Columbia rely to varying degrees on the property tax as a source of revenue. Each state has established rules governed by its state constitution and statutes. Although most state constitutions include a uniformity rule pertaining to property taxation, in practice, no two states have identical property tax systems, and in some states, rules are left to local discretion so that the system is not even uniform across the state. The purpose of this report is to describe similarities and differences in property tax systems across states focusing on the property tax base and the extent to which all property is or is not treated uniformly in current practice. [1]

The Tax Base: What is Taxable Property?

Property is often defined, for legal purposes, as the rights in or control over economic goods and is interpreted to refer to things or objects which may be the subjects of ownership. In most states the basic starting point in determining the property tax base is all real and personal property, both tangible and intangible. Real property commonly refers to land and anything permanently attached to it. Personal property includes anything that is the subject of ownership not permanently affixed to or part of real property. Tangible property is property that is discernable by touch. Intangible property includes money, stocks, bonds, credit, checks, share drafts, other drafts, notes, other written instruments, patents, trademarks, copyrights, brand names, franchise agreements, and licenses.

In no state is the tax base so broad as to encompass all real and personal property, and in no two states is it the same. For example, Illinois and Iowa include only real property in their tax bases and most states exclude intangible property. Florida, Kentucky and Missouri are among the exceptions that tax intangibles. Among the states that could constitutionally tax all real and personal property, none do. Instead, various means are used to remove property from the tax base. Certain types of property are granted full or partial exemptions based on characteristics of the property and/or its owner and in some states different types of property are assessed differently, or taxed at different rates. Exemptions and differential treatment are discussed below.

Basis of Value

Once taxable property is defined or identified, it must be valued for tax purposes. It is the value of such property that constitutes wealth or is the best yardstick by which to compare holdings and on which to base tax liability. Most states assert that the current “market” value of property should provide the basis of taxation. These are often referred to as market-value based systems. Market value is the price the property would sell for assuming that both the buyer and seller are unrelated, well-informed, and under no pressure to buy or sell the property. This value is often referred to as “true value”, “full value”, “cash value”, “full cash value”, “fair cash value,” or “fair market value.” Market-value based property tax systems require that all property be assessed at market value or some percentage thereof.

In California, market value only enters into the determination of taxable value at the time the property is acquired. In subsequent periods, the taxable value is determined by the application of a specified inflation factor (not to exceed 2 percent) and may deviate substantially from current market value. Such systems are referred to as acquisition-value based systems. Oregon has a system similar to California but allows annual assessment increases up to 3 percent. Georgia allows acquisition-value based assessment as a local option. Six other states limit annual increases in assessed values of individual parcels between sales. Arkansas and Texas limit assessed value increases to at most 10 percent per year. The Arkansas limit applies to all property while in Texas the limit applies to only homestead property (property used as primary residence of owner). Oklahoma has a 5 percent limit on all property and Michigan has a 5 percent limit for residential and business property. Florida and New Mexico both limit increases in assessments of residential property to 3 percent per year; however, Florida’s limit is restricted to homesteads. All of these limits are intended to protect the current property owner from excessive increases in their property tax burden due to rapidly rising property values. To the extent that these limits are binding, assessed values will, over time, deviate further and further from actual market values.

Acquisition –value based systems and market-value based systems that update appraisals infrequently introduce inequities into their property tax systems. For example, studies have shown that the assessed value of identical, similarly situated parcels in California may differ by 500% or more. [2] Such systems tend to favor infrequent movers and shift the property tax burden to frequent movers.

Fractional Assessment

Most state constitutions do not require assessments at full market value. Some states fix assessments at a uniform percentage or fraction of actual market value. For example, South Dakota assesses all property at 85 percent of market value, or uses an assessment ratio (ratio of assessed to market value) of 0.85. Similarly the assessment ratio is 0.7 in Connecticut and 0.6 in West Virginia. Nevada and Ohio have assessment ratios of 0.35, while the ratio in New Mexico is 1/3 and that in Arkansas is 0.2. In Michigan, assessed values are set at 50 percent of market value at time of sale.

Classified Property Tax Systems

Many states use a system of classification that specifies different ratios for different classes or components of property. These are commonly referred to as classified property tax systems. Classification systems typically involve differential treatment of properties based on use and often involve partial exemptions from taxation.

Twenty-five states have classified property tax systems. Such systems vary either the fraction of market value that is subject to tax (the assessment ratio) or the tax rate according to specific characteristics of the property (e.g. land versus improvements or real versus personal property) or according to specific uses of the property (e.g. residential, commercial, industrial, agricultural). Some systems call for different valuation methods in different circumstances. For example, the value of agricultural property may be based on its agricultural productivity as opposed to its highest and best possible use.

Sometimes all three mechanisms are used for effectuating differentials. Residential and agricultural properties generally receive the most favorable treatment in classified systems. Practices such as these date back to the colonial period when certain types of property were singled out to be taxed, sometimes at differential rates. It should be noted that either assessment ratio differences or tax rate differences, achieve the same end result, differential tax burdens. The tax burden on residential property can be reduced to half that of other property by either reducing the assessment ratio to half that applying to other property or by cutting the tax rate in half.

Table 1: Overview of Property Tax Classification Systems by State provides information on states that currently use a classification system, the number of classes in each system, and whether assessment ratios or tax rates vary across classes. Montana’s system includes the largest number of classes and varies the assessment ratio across classes. In contrast, New Hampshire has only two classes, utility and non-utility, and taxes them at different rates. **Table 2: Property Tax Assessment Ratios by Classification and State** provides

select examples of classified systems that vary the assessment ratio; while **Table 3: Property Tax Rates by Classification and State** shows how tax rates may vary.

Minnesota has one of the most complex classification systems. The assessment ratio varies according to not only the classification of the property but also its estimated market value. For example, the assessed value of residential homesteads is 1.0 percent of the first $500,000 of market value and 1.25 percent of value in excess of $500,000. Similar definitions apply to other classes of real property. In contrast, Utah's classification system singles out only residential property and assesses it at 55 percent of market value, while all other property is assessed at full market value. In the District of Columbia all property is assessed at full market value but residential property is taxed at a lower rate, 0.96 percent, than is commercial and industrial property, 1.85 percent, or vacant land, 5.0 percent. In most states with classification systems, assessment ratios or tax rates are set so as to reduce the burden on residential and agricultural property relative to commercial and industrial property.

Several cities in Pennsylvania have implemented a different form of classification. Their "two-tier" or "split-rate" property tax system taxes improvements (structures) at one rate and land at a higher rate. This distinction is an important one since the property tax on improvements has different equity and efficiency consequences than does the tax on land. Since land is in fixed supply, the economic incidence (or final distribution of the tax burden) of the property tax on land falls entirely on land owners and hence is distributed progressively (or more to those in higher income brackets). In contrast, the property tax on improvements may be shifted to consumers in the form of higher prices or to labor in the form of lower wages and hence may be distributed regressively (that is, more to those in lower income brackets). Thus a shift in burden from improvements to land will result in a more progressive property tax. In addition, the two taxes have significantly different impacts on incentives. Since landowners cannot react to an increased tax burden by reducing the supply of land, the behavioral impacts, and consequently the excess burden of the property tax, will be reduced by increasing the rate on land and lowering that on improvements. This shift has allegedly discouraged land speculation and encouraged development and more intensive land use in Pennsylvania cities. [3] Kauai County, Hawaii has also implemented such a system and it has attracted attention in New York, Maryland, and other states.

While only half of states today use a general classified property tax system applicable to all tangible property, most states provide for special taxation of some classes of real or tangible personal property. Some do so inadvertently by offering full or partial exemptions based on use or by using different assessment methods for different types of property. The classes of real property most frequently singled out for special taxation are forests, mines, and agricultural property. Among tangible personal property, vehicles, inventories and household or personal goods are generally treated differently. Infrequent reappraisals also tend to introduce differentials because different classes of property experience different rates and directions of value changes.

Agricultural land is frequently assessed according to its current use in agriculture. Such use-value assessment is commonly based on the rental value as agricultural land or the capitalized income from agricultural use. Maryland was the first state to adopt an agricultural use assessment law in 1960 to help preserve the State's agricultural land. In California and Pennsylvania the owners of agricultural or open space lands must sign contracts which commit the land to its current use for ten years in order to receive the lower use-value assessments.

Various arguments are used to justify the preferential assessment of agricultural and open space lands. Among them is the desire to encourage and assist the maintenance of productive agricultural and forest land; to encourage and assist in the conservation and preservation for future productive use and for the protection of natural ecological systems; to prevent the forced conversion of open space land to more intensive uses because of the economic pressures caused by the assessment of the land at rates or levels incompatible with its current use; to maintain a readily available source of food and dairy products close to metropolitan areas; to encourage and assist in the preservation and enhancement of scenic natural resources; to enable orderly growth in the face of increasing development pressures in the interests of the public health, safety, and welfare.

Planted timber generally does not yield any return for thirty to fifty years after planting. Property taxes must be paid annually by investors who will not see a return for many years. It is feared that the taxation of timber at ordinary property tax rates might stimulate cutting resulting in overproduction, reduced prices, and possible depletion of natural resources. This is why most states with extensive forest land generally separate the land from the timber for property tax purposes by imposing the annual property tax on the land only and imposing a yield tax on the timber at the time of harvest. Similar reasoning has led to special treatment of mineral properties. It may be very difficult to estimate the value of un-extracted minerals. In many states, full or partial property tax exemptions are given to mines and severance or yield taxes are collected in lieu of property taxes.

Among the various classes of personal property, special treatment is most common in the case of motor vehicles. Many states impose some form of license tax in lieu of general property taxes. In some cases, these vehicle license fees are based on the value of the vehicle and thus are essentially a personal property tax but are collected separately, at a different time, and by a different agency than the general property tax.

Differential Treatment of Certain Properties: Exemptions

Although uniform rule provisions, calling for uniform taxation of all taxed property, were written into most state constitutions during the latter part of the nineteenth century, these provisions allow state legislatures considerable freedom in determining what property is taxable. No state taxes all real and personal property uniformly. Some property is exempt from taxation entirely and certain types or classes of property are treated differently either in arriving at the taxable value or in the tax rate applied to taxable values. Exemptions are either tied to the specific use of the property such as educational, religious, charitable, and nonprofit uses or to ownership. Most ownership based exemptions involve real property that is publicly owned by various levels of government. Examples include parks, public schools, water and sewage treatment systems, public transportation systems, and government administration buildings. It is common practice to exempt public property entirely. With respect to private property, exemptions are sometimes used as incentives to stimulate certain types of activities.

Institutional exemptions are granted to legal entities rather than individuals. Examples include property owned by governments and used for governmental purposes, as well as property owned by charitable, educational, and religious institutions and used for stipulated (non-profit) purposes. These types of properties are usually granted full exemptions of indefinite duration though initial application and periodic reapplication may be required. **Table 4: Common Property Tax Exemptions by State** is a state-by-state listing of the common exemptions described below.

Property used for educational purposes

All 50 states and Washington D.C. exempt public school property. Exemption of private schools is also often granted on the grounds that they supplement state services, or must compete with public schools, which enjoy such exemption.

Other common exemptions for educational purposes include libraries that are free and open to the public, non-profit educational associations, non-profit literary and scientific societies, and the property of college fraternities and sororities.

Property used for religious purposes

The exemption of religious property is very common and generally justified on the basis that such uses are meritorious and should be encouraged. The constitutionally required separation of church and state has generated considerable controversy concerning this exemption. Nonetheless, virtually every state and the District of Columbia exempt property owned by religious organizations and used for religious purposes.

Property of charitable institutions

The property of charitable institutions is exempt in most states unless they are profit-making organizations. Although the purposes for which they exist vary widely, the rationale for exemption lies in the view that charitable institutions generally attempt to provide relief to some segment of society and therefore relieve the state government from such obligations.

Government property

Property owned by the Federal Government is generally exempt because of an implied prohibition of the Federal Constitution. It is also common that either constitutional provisions or statutes exempt property owned by state and local governments. The standard justification of the exemption of public property is that it is used for public purposes and not for profit. Also it would be inefficient for a governmental unit to incur the administrative costs of taxing the property it owns.

Other exempt property

States may also provide a range of other exemptions from property taxation.

Some states authorize the exemption of the property of fraternal and benevolent societies even though there is little social or economic justification for this subsidy. Property owned by veterans organizations is exempt in most states presumably to show gratitude to those who have served in the military. Some states have chosen to impose other taxes in lieu of property taxes, thus exempting certain types of property from the property tax. Common examples include yield taxes on growing timber, severance taxes on mines and minerals, and gross receipts taxes on certain utilities.

Business or manufacturing inventories are also often excluded from the tax base either because of difficulty in measurement, to avoid double taxation in cases where the goods are subject to a sales tax when sold, or to provide an incentive to such industries. A number of states also constitutionally or statutorily exempt growing crops from the property tax base. This exemption is sometimes limited to annual crops and is intended to avoid the taxation of both the land and the income under the property tax. Livestock exemptions are similarly justified in some states.

It is worth noting that the value of certain types of exempt property such as parks or schools may be reflected in the values of adjacent properties and hence be captured, indirectly, in the tax base. Further, if such properties are subject to tax, other taxes would have to be raised to pay the taxes on the locally beneficial exempt property-a case of the government taxing itself. Of course, if government owned property is used for purposes for which the government competes with private sector providers, for example schools, the tax exemption could give the public entity an unfair advantage. For this reason many states exempt all property used for educational purposes, whether publicly or privately owned.

Most states either wholly or partially exempt household goods and personal effects. It is commonly argued that the tax applied to such items would be highly regressive. The more believable explanation has to do with the difficulty and cost of assessing such property relative to the revenue generated by its taxation.

All of these property tax exemptions reduce the tax base and consequently shift the tax burden to owners of nonexempt property or payers of taxes other than the property tax. Another problem raised by exemptions occurs to the extent that exempt property is unequally distributed among taxing jurisdictions. Those jurisdictions with a high concentration of exempt property must tax non-exempt property more heavily. A possible remedy for this discrimination, without eliminating exemptions, would involve expanding the size of or consolidating taxing jurisdictions.

While few would argue against public property exemptions on the basis of the inappropriateness of government taxing itself, it is harder to justify exemptions of private property, and when justified such privilege should not carry the force of irrevocable contracts by being incorporated in state constitutions or special charters. This type of subsidy to private activity could be justified if the use of the property results in external social benefits to residents of the taxing jurisdiction that is granting the exemption. In such instances, the subsidy is needed to foster an adequate or optimal amount of the service in question since individuals, in general, consider only their personal benefits. It is important, however, that the social benefits do not spill over into other taxing jurisdictions as it is only the taxpayers in the exemption-granting jurisdiction that will pay for the subsidy in the form of high taxes.

Incentives

Some exemptions and relief measures are granted for the purpose of providing incentives to undertake certain socially or economically desirable activities. These are often referred to as developmental exemptions. Common examples include incentives for agriculture, forestry, open space preservation, historic property preservation, environmental improvements, industrial development, and housing development. Incentives in the form of exemptions are usually only partial and are often available for a limited period of time with the amount of exemption declining over the period. These exemptions may also be limited to specific geographic areas within the taxing jurisdiction, such as "enterprise zones" or "redevelopment districts." **Table 5: Common Property Tax Incentives by State** provides information on some of the most commonly provided incentives described below.

To foster the agricultural industry, most states offer full or partial exemptions of agricultural products, crops, livestock, machinery and equipment. Agricultural land is also frequently afforded preferential treatment through partial exemption, more favorable current use and income based assessment, and/or lower tax rates. For example, Kansas provides a full exemption for farm machinery and equipment "to promote, stimulate and develop the general welfare, economic development and prosperity of the state of Kansas by fostering the growth and development of agricultural endeavors within the state." [4] Farms and ranches require large amounts of land and machinery and equipment to satisfactorily carry out such endeavors. Many states whose economies are dependent upon agriculture fear that the property tax may be a deterrent to such investment and, in some instances, an encouragement to farm and ranch abandonment. It is believed that crop, livestock, machinery and equipment exemptions and preferential assessment of agricultural land will constitute an incentive to agriculture and will improve the general economies of these states.

Incentives designed to encourage manufacturing activity are also widely used. Statewide exemptions of manufacturing property are granted in 18 states while geographically restricted exemptions are available in many others. Manufacturers' inventories and/or equipment are frequently exempt and partial exemptions for real property are also common although they generally expire after a certain period of time. Four states (Maryland, Mississippi, Oklahoma, and South Carolina) that grant exemptions to manufacturing businesses grant similar exemptions to research and development enterprises.

Property tax abatements are used to encourage a business to locate or expand at a location or to redevelop an area. Abatements may be either permanent forgiveness or temporary deferral of property tax and can serve similar purposes to tax increment financing, a widely used development tool, but are more flexible. Common uses of abatements include general economic development such as increasing the tax base or the number of jobs in an area; construction of public facilities or infrastructure; and redevelopment of blighted areas.

Seventeen states currently offer exemptions or abatements to new or expanding businesses in specific zones. These are typically blighted areas that have been targeted for redevelopment. Eligibility for these exemptions or abatements usually requires a minimum threshold of new investment and/or new job creation and are available for a limited period of time ranging from 2 to 20 years.

Many states offer exemptions for business incubator property. A "business incubator" is commonly defined as a facility used for the development of non-retail businesses, offering access to equipment, space, services, and advice to the tenant businesses, for the purpose of encouraging economic development, diversification, and job creation in the area served by the organization.

Several other exemptions are commonly granted as incentives to new or expanded activities. These include exemptions of pollution control facilities which are granted in 24 states and exemptions of energy facilities, especially alternative or renewable energy, which are currently granted in 19 states. In some locations, new residential properties and/or improved and rehabilitated residential properties are granted full or partial exemptions, particularly if they are targeted for low-income, senior, or disabled households. Fourteen states currently offer such incentives in certain cities. New York exempts new low-income residential property in New York City. Another redevelopment incentive is the full or partial exemption of sports stadiums which is granted in 7 states.

Tax Relief for Certain Taxpayers

Various provisions exist to cushion taxpayers from excessive property tax burdens. Most classified property tax systems favor residential property but there are many ways in which relief is granted to homeowners and/or renters. Some relief programs are comprehensive, providing relief to all residential property taxpayers. Others target the relief to only the elderly, the disabled, veterans, or those with lower incomes. **Table 6: Property Tax Homeowner Relief Programs by State** provides a summary of the types of relief programs available in each state.

The most common form of relief for homeowners is referred to as a "homestead exemption" which allows a partial exemption of the assessed value of the person's principal residence. The exemption may apply to all property taxes levied against the homestead or be restricted to a subset, usually school levies. In 14 states a fixed amount of the homestead value is exempt from the property tax, ranging from $1,000 in Oklahoma to $52,500 in some South Carolina jurisdictions. In other states, the exempt value is determined as a percentage of market value. Ohio exempts 12.5 percent of owner-occupied property while South Dakota provides a full exemption (100 percent) from state taxes and Michigan's full exemption for homestead property applies to school levies.

Another approach is to provide income tax credits or rebates of a portion of the taxpayer's property tax liability. Such programs are frequently means tested meaning that only persons with incomes below a certain limit qualify for relief. The amount of relief may fall as income rises toward this limit. "Circuit-breaker" relief programs place limits on the proportion of an individual's or household's income that can be collected as property taxes and the excess taxes are waived, rebated, or credited against income tax obligations. If property taxes exceed a threshold percentage of income, the refund equals a percentage of the tax over the threshold, up to a maximum amount. As income increases, the threshold percentage increases; the portion of tax over the threshold that the taxpayer must pay increases; and the maximum refund decreases. Five states (Maine, Maryland, Minnesota, Vermont, and Wisconsin) currently have circuit breaker relief programs for all homeowners.

Many states have chosen to target property tax relief to only certain classes of homeowners such as senior citizens, disabled, blind, and/or veterans while some states with general homeowner relief provide additional relief to these households. Again, the fixed or percentage value exemption is the most common and is available to seniors (age 65+) in 35 states. Connecticut Missouri, Montana, Oklahoma, Utah, and Wyoming have senior circuit breaker programs.

Another form of relief often available to seniors is that of a tax deferral whereby the property owner can defer the payment of all or a portion of their property taxes until they die or sell their property. There are generally limits placed on how much can be deferred, usually 80 to 85 percent of home equity. Eleven states offer seniors yet another form of relief: a tax freeze. These programs prevent the property tax levy on a homestead from increasing beyond some base year, usually the year the owner turns age 65.

Eligibility for these various senior relief programs usually requires more than satisfying the age requirement. Usually household income cannot exceed a predetermined threshold. Annual income thresholds vary from state to state and over time and currently range from $12,000 to $100,000.

Additional relief is available to disabled or blind homeowners in 33 states. Of these, 14 states have income eligibility requirements. Veteran relief programs are also very common (33 states). The magnitude of relief under most of these programs depends on the degree of disability with full exemptions from the property tax for permanently and totally disabled veterans in several states.

Conclusion

Although the property tax is a critical component of local government finance in every state, it is certainly not uniformly applied. There is considerable variation across the states in laws, rules, and definitions. Tax rates generally vary from jurisdiction to jurisdiction within a given state but in some cases classification, valuation, and exemptions are also left to local discretion. For example, each county in Hawaii has its own property tax system. In comparing differences across states it is important to note that exemptions, classification systems, and relief programs are all ways of providing incentives or shifting tax burdens by excluding some property from the tax base. All states utilize one or more of these methods and even states with the most elaborate or complicated classification systems such as Kentucky, Minnesota, and Montana, also grant full exemptions to certain categories of property and provide property tax relief to senior, disabled, veteran, and/or low-income households.

Property tax systems in the United States are dynamic and any summary such as this can only provide a snapshot at a point in time. The decade of the 1980's is often referred to as the "tax limit era," in which many states passed tax limit legislation or, as in the case of California, taxpayers passed initiatives to amend their state constitutions so as to place limits or restrictions on rapidly rising property tax burdens. Many states introduced new, or expanded existing, exemptions and relief programs. The decade of the 1990's brought a continuation of this effort, as the property tax was determined, in many states, to be an unconstitutional source of school finance. Many states reduced their reliance on the property tax in favor of either income or sales taxes. This type of reform continues today with more attention to the differences between the property tax on land and that on improvements. Perhaps this decade will be remembered by major shifts from general property taxes toward land value taxes.

Finally, this report is not intended as a comprehensive review of all aspects of all property tax systems in the United States, but rather, an attempt to provide the reader with an appreciation of the diversity of property tax systems in operation today.

[1] The sources of information for this report include state constitutions, statutes, and other information available on state and local government websites. Appendix A contains the web addresses for each state where this information was found or, at least, where the search began.

[2] O'Sullivan, Arthur, Terri A. Sexton and Steven M. Sheffrin, *Property Taxes and Tax Revolts: The Legacy of Proposition 13*, Cambridge University Press, 1995.

[3] Hartzok, Alanna, "Pennsylvania's Success with Local Property Tax Reform: The Split rate Tax," www.earthrights.net/docs/success.html

[4] Kansas Statutes, Chapter 79, Article 2, Section 79-201i, modified 03/12/2003.