MINNESOTA • REVENUE

January 30, 2015

The Honorable Rod Skoe
Chair, Senate Taxes Committee
235 Capitol
75 Rev. Dr. Martin Luther King Jr. Blvd.
St. Paul, MN 55155-1606

The Honorable Dave Thompson
Ranking Minority Member
Senate Tax Reform Division
State Office Building, Room 131
St. Paul, MN 55155-1206

The Honorable Ann H. Rest
Chair, Senate Tax Reform Division
235 Capitol
St. Paul, MN 55155-1606

The Honorable Greg Davids
Chair, House Taxes Committee
585 State Office Building
St Paul, MN 55155

The Honorable Julianne E. Ortman
Ranking Minority Member
Senate Taxes Committee
State Office Building, Room 119
St. Paul, MN 55155-1206

The Honorable Ann Lenczewski
Ranking Minority Member
House Taxes Committee
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St Paul, MN 5515

The Honorable Steve Drazkowski
Chair, Property Tax and Local Government Finance Division
591 State Office Building
St Paul, MN 55155

The Honorable Jim Davnie
Ranking Minority Member
Property Tax and Local Government Finance Division
393 State Office Building
St Paul, MN 55155

To Members of the Legislature of the State of Minnesota:

We are pleased to present this report on Class 4d Tier Structure undertaken by the Minnesota Housing Finance Agency and the Department of Revenue, as required by Minnesota Laws 2013, Regular Session, Chapter 143, Article 4 section 45.

This report presents information on class 4d properties. It finds that 61 class 4d properties are subject to the second tier of market value and that second-tier properties are more likely to be in communities that have higher incomes and are growing more rapidly. The report also analyzes the characteristics of the second tier market value properties, such as location, building type, and number of units. Please let us know if you have any questions related to the findings in this report.

Sincerely,

Cynthia Bauerly
Commissioner
Minnesota Department of Revenue

Mary Tingerthal
Commissioner
Minnesota Housing Finance Agency

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Minnesota Housing Finance Agency

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Report on Class 4d Tier Structure

In 2013 session laws Chapter 143, the Legislature mandated a report by the Commissioners of Revenue and Housing Finance on the tiered tax structure of class 4d properties.

> **Chapter 143, Sec. 45**
> The commissioners of revenue and housing finance shall report to the legislature by January 31, 2015, on the implementation of a second tier of market value for class 4d property under Minnesota Statutes, section 273.13, subdivision 25, paragraph (f). The report shall include the number of class 4d properties subject to the second tier of market value for taxes payable in 2015 and the tax impact of the application of the second tier of market value. The report shall also include an analysis of the characteristics of the properties to which the second tier of market value applies, such as location, building type, and number of units.

Background

The Legislature has set the property tax classification rates in Minnesota Statute 273.13, which are based on the use of the property. The classification rate is multiplied by the property's taxable market value to arrive at the property's net tax capacity.

Classification rates can be tiered, typically, in a progressive manner so the rate increases as the value increases above a set amount. However, the classification rates for low-income rental housing are unique because the second-tier rate decreases as value increases above a set amount.

The class rate for class 4d property decreases from 0.75% on the first tier to 0.25% on the second tier. Each year, the first-tier value limit is indexed for inflation in market values of apartment properties. The Commissioner of Revenue certifies the first-tier value amount by November 1 for the upcoming assessment year.

- For the 2014 assessment (taxes payable 2015), the tier limit is the first $100,000 of unit value
- For the 2015 assessment (taxes payable 2016), the tier limit is the first $106,000 of unit value

For example, in a class 4d building, one unit valued at $150,000 in 2014 has net tax capacity of $875 calculated as follows:

First-Tier	$100,000	x	0.75%	=	$750
Second-Tier	$50,000	x	0.25%	=	$125
Total				=	$875

In comparison, a unit valued at $150,000 in an apartment building that is not a class 4d building with a class rate of 1.25% on the entire value would have a net tax capacity of $1,825.

The assessed value of low-income rental housing is determined using the same methodology as other rental housing property. Even though the rents are restricted for all or portions of the property depending on how many units qualify for class 4d in the building, assessors are required by statute to base the market value on "normal unrestricted rents." [See M.S. 273.13, subdivision 25, paragraph (e).] A property with qualifying 4d units and a property without any 4d units would have the same assessed value even though the property with restricted rents will generate less income.

Because the tier limit is applied to individual housing units, the value of individual units must be estimated. When a building is not certified as 100% class 4d, only a portion of the units qualify for the 4d classification based on the ratio of qualifying units to the total number of units in the building. The remaining portions of the buildings are classified by the assessor based on use (typically class 4a apartments). The class 4d calculation also includes the value of the same proportion of land as the qualifying low income rental housing units are to the total units of the building. For all properties qualifying for class 4d, the market value must be based on the normal approach to value using normal unrestricted rents.

Valuation and Tax Effect of Second-Tier Parcels and Units

In total, 105 parcels included some value in the second-tier classification rate for the 2014 assessment (taxes payable in 2015). These parcels were located in seven counties, with the majority in the Minneapolis and St. Paul metro area. Seventy two percent of all parcels that had second-tier value were certified as 100% low-income rental housing with restricted rents.

The number of units per parcel ranged from single-family homes (such as townhouses) to a complex with 228 units. Counts of second-tier units by county (with Minneapolis separated from Hennepin) are shown in the table below. Of the nearly 65,000 units in the 4d classification, there are only 1,759 units (2.7%) with a second-tier value.

Table 1: Number of 4d Second Tier Units by County

	Total 4d Second-Tier Units
Anoka	83
Blue Earth	53
Clay	4
Dakota	396
Hennepin (without Minneapolis)	528
Minneapolis	391
Ramsey	149
Scott	155
Totals	**1,759**

The Table 2 shows second-tier value by county.

Table 2: Second-Tier 4d Values

	Second-Tier 4d Value
Anoka	$2,620,900
Blue Earth	$1,680,100
Clay	$20,000
Dakota	$4,816,300
Hennepin (without Minneapolis)	$13,080,900
Minneapolis	$10,946,100
Ramsey	$2,857,200
Scott	$326,800
Total	**$36,348,300**

Tax Impact

The lower class rate on the second-tier that takes effect for taxes payable in 2015 will result in total tax savings of about $250,000 for all 105 parcels in 2015.[1] On average, this is about a 10 percent reduction in taxes for these parcels. For a typical building with an overall value of $4 million, this would mean an annual savings of approximately $2,400.

The $250,000 in taxes will be paid by and spread across all other parcels in those jurisdictions. This represents about 1/100th of 1% of the taxes paid in those jurisdictions.

Property Characteristics

The Minnesota Housing Finance Agency tracks the 4d classification on a property basis, rather than a parcel basis. For example, a townhome development with 10 individual parcels and a single owner is tracked as one property. Currently, 1,653 properties are tracked under the 4d classification by Minnesota Housing, with 61 having a second-tier value. (The 105 parcels referenced in the previous section are aggregated into the 61 properties tracked by Minnesota Housing.)

- The second-tier units are more likely to be multi-bedroom units. For example, 35 percent of the units with second-tier value have 3 or more bedrooms. In contrast, only 11 percent of the units in 4d buildings with no second-tier value have 3 or more bedrooms.[2]
- The second-tier properties are more likely to be in communities that have higher incomes and are growing more rapidly. These properties also appear to be in communities with higher homeownership rates, higher performing schools, and better access to high-frequency public transit; however, the differences between the second-tier and non-second-tier properties are not statistically significant for the latter three characteristics.
- There is little or no difference in the average number of units in each type of property.

Table 3: Characteristics of 4d Properties in the Metro Twin Cities Area by Tier Status

	Average Median Income of Census Tracts in which the Properties are Located*	Average Percentage Increase in Number of Households in Census Tracts (2000-2012)*	Average Home-ownership Rate of Census Tracts in which Properties are Located	Share of Properties with High Performing Neighbor-hood Schools [a]	Share of Properties with Access to High-Frequency Transit Services [b]	Average Number of Units in Property
Properties with Second-Tier Value	$59,597	33%	56%	59%	44%	66
Properties without Second Tier Value	$49,972	16%	51%	48%	38%	67

* Differences are statistically significant.
a. To be classified high performing, the neighborhood schools' proficiency and graduation rates must be higher than the overall state rate for 2 of the following 3 metrics: (1) 3rd grade reading, (2) 5th grade math, and (3) high school graduation.
b. The property must be within: (1) ½ mile of a light rail, bus-rapid-transit, or commuter-rail station, or (2) ¼ mile of Hi-Frequency bus stop, as defined by the Metropolitan Council.

[1] With a 36.3 million in tier-2 value and a 0.5% differential between the first-tier rate (0.75%) and the second tier rate (0.25%), there is a tax capacity reduction of $181,742. The average local tax rate for these properties is 1.366, which results in tax savings of $248,218.

[2] This is based on a sample of 10,468 units in non-tier-2 4d properties.

The figures in the previous table apply only to properties with a 4d classification in the seven-county Twin Cities region. Of the 61 properties with a 4d classification and second-tier value, 59 are in the Twin Cities region, and only 2 are in Greater Minnesota.