Agenda Item 4
December 3, 1991

MEMORANDUM

TO: County Council

FROM: MF Michael Faden, Senior Legislative Attorney

SUBJECT: Final Action: Bill 34-90, Excise Tax - Construction

Bill 34-90, Excise Tax - Construction, sponsored by Council President Leggett, Council Vice-President Adams, and then-Councilmember Potter was introduced on March 13, 1990. A public hearing was held on April 19, 1990. On April 27, 1990, the Council voted 4-3 not to consider Bill 34-90.

The Council held another hearing on Bill 34-90, and other revenue measures, on April 2 and 4, 1991. The Management and Fiscal Policy Committee held a worksession on Bill 34-90 on April 16, and recommended that the bill pass with amendments. At a worksession on May 14, the Council adopted a number of amendments. On September 24, the Council voted to defer action on Bill 34-90 until December 3, to allow time to consider the relationship of potential development district legislation to this bill. On November 26 the Council discussed a proposal from the Executive branch for an approach to infrastructure funding that included development districts and the construction excise tax, and informally directed the Executive branch to proceed with the drafting of appropriate legislation.

Council amendments

This section of the memo will describe the amendments adopted by the Council at its May 14 worksession.

Rates The Council adopted the following rate schedule ($ per square foot of gross floor area):

Single-family Residential	**$3.75**
Multi-family Residential	**$3**
Warehouse, Manufacturing, Research and Development, and Nonprofit Office	**$2.40**
Other non-residential (e.g. office, retail)	**$4**
Nonprofit care-giving facilities, private schools	**$1**

For most categories, these rates are lower than the rates recommended by the Executive and the MFP Committee.

Exemptions The tax will not apply to the first 1200 square feet of any building, and to the first 1200 square feet of each dwelling unit in a multi-family building. The Council rejected the MFP Committee recommendation for a graduated scale of exemptions for multi-family dwelling units based on the number of bedrooms in the unit.

Also exempted are buildings used primarily for religious activities and Moderately Priced Dwelling Units, Productivity Housing Units, and similarly price- and rent-controlled housing units.

"Gross Floor Area" The Council redefined "gross floor area" — the standard of measurement by which the tax is applied — to include all enclosed spaces in a building except:
— unfinished basements or attics with less than 7'6" headroom;
— interior amenity spaces that are required for site plan approval;
— the "upper floors" of atria and other multi-story spaces;
— parking garages; and
— accessory structures that are not separate buildings (e.g. decks, loading docks).

Time of payment The Council decided that 50% of the tax must be paid at occupancy (in a building with multiple stages of occupancy, issuance of the first occupancy permit). The MFP Committee had recommended that 100% be paid when the building permit is issued. Since the May worksession, the Executive has changed his position and now supports 100% payment at occupancy, so the Council may revisit this issue (see Issue 6).

Effective dates The tax will apply, at 50% of the full rates, to buildings with permits issued on or after April 1, 1992. The full rates will apply to buildings with permits issued on or after April 1, 1993. The tax will expire on June 30, 1996.

Issues

1) Will this tax produce enough revenue, at the rates proposed, to achieve its purpose?

Under the Executive's infrastructure funding proposal outlined on November 26, the construction excise tax is intended to fund needed transportation capital projects outside the development districts. Inside the development districts it would be replaced, at least partially, by a development impact excise tax targeted to the particular area. The latest revenue estimates prepared by OMB (circle 62-64), based on the Planning Department's intermediate construction forecast, show that this tax will raise about $13 million a year when it is fully effective. Of that, the first $5 million is dedicated to the Housing Initiative. If anything, OMB's estimate may be high because it assumes only 15% of the total revenue will be lost to credits for the impact taxes in Germantown, Eastern Montgomery County, and Shady Grove (if enacted), while in our view more than 15% of the total construction in the County will probably occur in those 3 areas.

The Council's previous discussions evaluated the tax's rates almost exclusively in terms of impact on developers and the housing market. These factors are of course legitimate, but up to now the Council has not focused on any specific revenue goal as distinct from generally augmenting the County's ability to fund infrastructure. The Executive's infrastructure funding proposal suggested a goal against which this tax's projected yield could be measured. Assuming the Council agrees with this goal, the question then becomes: does the projected yield — very roughly, about 30% of the annual cost of transportation debt service in FY 1992 or 50% of the annual roads and bridges CIP during the next 6 years — represent the share of Countywide transportation capital costs that new development should directly pay? If so, the proposed rates are adequate. If not, the rates should be adjusted either upward or downward. (The Council can revise the rates of this tax after it is enacted as well as before. See circle 4, lines 8-10.)

The Executive would prefer to reinstate the original higher rates, and lower them if the legislature gives the County its own gas tax or another way to pay for improved transportation infrastructure. (See memo, circle A1.) See also West*Group's letter, circle 50, arguing for reduced rates on competitiveness grounds.

2) Should nonprofit nursing homes and life-care centers be taxed as housing or as caregiving facilities? Or be exempt from the tax?

Under the rate structure approved at the May worksession, we understand that the construction of a nonprofit nursing home would be treated as a caregiving facility and taxed at $1 per square foot, but a profit-making nursing home or a residential life care community would be taxed at the residential rate of $3 a square foot. Does this match the Council's intention? If so, we will either clarify the bill or see that the minutes and legislative history reflect this intention.

A continuing care retirement community has proposed that such developments be exempt from the tax altogether (Strawbridge Run letter, circle 59). Should these communities be grouped with low- and moderate-income housing as exempt classes? Since continuing care communities tend to charge high rates and serve affluent populations, staff does not recommend this exemption.

3) Should buildings used for higher education be exempt from the tax?

Johns Hopkins University complains that it would be placed at a further competitive disadvantage to the University of Maryland and other public higher education institutions if it has to pay the excise tax, even at the $1/square foot rate that applies to nonprofit educational institutions. (See letters, circle 52.) Councilmember Hanna would exempt them, Columbia Union College, and any other future private post-secondary institutions by inserting the following after circle 6, line 8:

<u>(f)</u> <u>a building or part of a building owned by an accredited college or university and used exclusively for instruction, instruction-related research, and administration of higher education programs;</u>

This clause would exempt classrooms, academic research laboratories, and academic administration offices from the excise tax, but would not exempt private office buildings that happen to be owned by a university.

The arguments for exempting private universities are set out in the Johns Hopkins and High Technology Council letters. The counterargument might be that private elementary and secondary schools (and for that matter, private day care centers and other human service facilities) serve similar public functions, and yet they are taxed under Bill 34-90, so why should higher educational institutions be exempt? Is it simply because they are more prestigious, or do higher educational institutions bring more tangible or indirect economic benefits?

4) Should replacement buildings be exempt from the tax?

Reconstruction and alteration of existing buildings is exempt from the tax (circle 5, lines 10-12). Attorney Harry Lerch asked whether this exemption would cover replacement buildings — that is, when an old building is torn down and a new one built in its place, with no additional square footage.

Staff's view is that the exemption as written does not cover this situation. Should the exemption be broadened to cover replacement buildings that do not exceed the size of the demolished building? If so, should it also exempt that part of a larger replacement building that is equal to the square footage of the demolished building?

Mr. Lerch argues that the law governing APFO treatment of loophole properties allows similar treatment of replacement buildings, and that a new building will bring in more sales and income tax revenue. Allowing this exemption might provide an incentive to upgrade existing business districts, but it also would favor some commercial construction at the expense of others. If the Council approves this exemption, in our view it should be limited to buildings that receive a construction permit not more than 6 months after the previous building is demolished.

5) Should credits against this tax be allowed for other taxes or private expenditures?

A) Introduction

Under Bill 34-90, credits would be allowed for amounts paid for other taxes that in some way duplicate the construction excise tax. The Council did not discuss this issue at the May 14 worksession. The Management and Fiscal Policy Committee bill includes the following:

[[~~52-49~~]] <u>52-62. Credits.</u>

<u>Any person who must pay the tax levied under Section</u> [[52-47]] <u>52-60 may reduce the tax due by:</u>

<u>(a)</u> <u>any amount the person paid under</u> [[Section 52-]] <u>Article VII (development impact tax) for the building that is the subject of this tax; and</u>

<u>(b)</u> <u>any amount the person paid or is required to pay for any development district tax levied under County law, to the extent that the development district tax is in addition to (and not a part of or substitute for) the ad valorem real property tax levied on the building that is the subject of the tax under Section 52-60.</u>

The first credit allowed, under §52-62(a), is for the development impact tax now levied in Germantown and Eastern Montgomery County. The developer could deduct the amount of impact tax paid from whatever it owes for the excise tax, and would pay any additional amount due for the excise tax. In effect, the developer pays the higher of the two taxes.

The Committee inserted §52-62(b) on Councilmember Hanna's motion to establish the principle that a credit should be allowed for a development district tax. Committee Chair Praisner preferred to see what kind of development district tax is enacted before approving a credit for it. Staff drafted subsection (b) to exclude development district taxes that are property taxes or substitutes for the property tax, such as the tax levied in a tax increment financing district created under state law [Art. 41, §14-201 et seq], because the County cannot adopt property tax credits without express state approval and this credit could be construed as a direct or indirect property tax credit.

Developers have argued that credits should also be allowed for other expenditures required by the County or paid to build a project faster, such as "road club" payments and traffic mitigation expenses. The MFP Committee discussed this issue extensively and expressed interest in a broader set of credits, but specified only those credits mentioned above. The Executive supports a credit for the development district tax but prefers to adopt it when that tax is enacted, and does not support other credits. (See Executive's July 12 memo, circle A1.)

B) Possible criteria

Allowing credits for other taxes, not to mention private expenditures, would potentially sacrifice much of this tax's revenue yield. It also raises questions of equity that involve the reasons for enacting this tax — that is, whether this excise tax is intended to pay for only specific infrastructure items as the impact tax was, or whether it is intended to cover broader costs of growth as well.

In deciding whether to allow a credit against the construction excise tax for another tax paid (e.g. a development district excise or impact tax) or for a direct private expenditure (e.g a road club), staff proposes the following criteria:

a) Does the other tax or expenditure fund the <u>same infrastructure needs</u> (e.g. roads, schools) as the construction excise tax does? If the other tax or expenditure pays for the same kind of projects, a credit against the construction excise tax may be justified.

b) Does the construction excise tax pay the <u>full cost</u> of the infrastructure needs it funds? In other words, would the other tax (e.g. a development district tax) or private expenditure replace only the construction excise tax, or would it also replace revenues from the property and income taxes? If the other tax would shift costs from the property or income taxes, a credit against the construction excise tax probably is not justified.

c) Does the payer of the other tax or private expenditure receive a <u>special economic benefit</u> (e.g. faster development, higher density, APFO compliance) for paying it? If so, a credit probably is not justified.

C) Private expenditures — special issues

In applying the "special economic benefit" test to <u>non-tax expenditures</u>, a distinction might be made between payments to the County for the basic right to develop a property and those made to move a project to completion earlier. The developer expenditures <u>necessary to develop a property</u> include permit application and other fees, site plan implementation costs (e.g. internal roads, stormwater ponds), stormwater management fees, and land dedications (e.g. school sites, parks). Often land dedications and site plan requirements do not result in any loss of density for the developer. Developer expenditures that are not legally required to develop a property, but which <u>make possible earlier development</u> than would otherwise be allowed under the Annual Growth Policy staging ceilings, include local area and policy area improvements such as offsite road mileage, intersection improvements, or traffic mitigation programs.

In our view, the latter class of expenditures implement the developer's business decision to invest funds "up front" in order to build a project sooner. As someone said, "The developer pays the County instead of the bank." However, these expenditures do benefit the public as a whole by improving transportation capacity for everyone; even if a road is required to serve a particular development, it is of course not used only by that development's occupants. By the same token, other residents also suffer from the effects of that development and that road: congestion, noise, air pollution, among others.

D) Partial credits?

Finally, the Council might ask: Should any credit be allowed on a dollar-for-dollar basis? In other words, should a credit be given for 100% of the other tax paid, or only for part of that payment (e.g. 50%)? A lower credit may be especially valid for private expenditures, where the County has no direct control over the amount spent and so might want to give the developer an incentive to limit costs. If credits for private expenditures are allowed, the County should also be prepared to audit those expenditures closely to confirm that unnecessary or unrelated costs are not included in the claim for credit.

Perhaps a fair solution (or an uneasy compromise) would be to allow a partial credit — say 33 or 50% of the developer's out-of-pocket expenditures — for voluntary contributions that underwrite the County's infrastructure needs. For an expenditure to be credited, the infrastructure item should be in the strategic plan approved by the Council, to be sure that it is needed in the relatively near future.

E) Relationship to impact tax credits

A related issue is: **Should the credit under the existing impact tax law for building an impact highway be transferable to the excise tax?** Under the impact tax law, a developer who builds all or part of an offsite road that is on the list of roads to be paid for by the impact tax receives a dollar-for-dollar credit for its expenditures, up to the amount of the impact tax due. The question then becomes: should the applicant receive a credit under the excise tax for only the amount of impact tax actually paid, or also for the amount spent on a road and credited against the impact tax?

This is a difficult issue because either result — allowing the credit or denying it — will treat similarly situated developers differently because of the accident of their property's location either inside or outside an impact tax district. The ideal solution would be to repeal the impact tax entirely and let the excise tax replace it, but the County Attorney believes that repealing it will weaken our defense against lawsuits attempting to recover previously-paid impact fees. We would recommend that the impact tax credit be transferable only to the extent that a developer outside the impact tax areas who contributes to a transportation improvement will also receive a credit for its similar expenditure. In our view, this best achieves (albeit imperfectly) the goal of equal treatment of developers Countywide.

6) Should the time for payment of the tax be moved to the issuance of the occupancy permit?

At the May worksession, the Council decided to make 50% of the tax payable at building permit issuance and the remaining 50% at the issuance of the first occupancy permit, or before the final inspection for buildings that do not receive occupancy permits. The original bill had required the entire tax to be paid when the building permit is issued, and developers strongly objected that up-front payment would pose a hardship to them because they receive no revenue (except construction loans) at that time. The Executive had opposed the change to 50% payment at occupancy.

Now the Executive has proposed (see July 12 memo, circle A1) that the entire tax be paid at occupancy. This would postpone the receipt of 50% of the revenue for, on average, a year or more. This change would not affect the amount of tax collected, because that is determined when the building permit is issued (or applied for; see next issue). If the developer does not pay the tax, the County could attach a lien to the property, so we don't see many tax collection problems stemming from this postponement. However, some revenue could be lost when developers who would have paid half of the tax when the building permit is issued don't complete their projects. The issue here is mainly whose cash flow needs should be served, the County's or the developer's.

7) Should the tax be triggered by the filing of a completed application for a building permit, instead of the issuance of the permit?

The version of Bill 34-90 before you makes this tax take effect for construction for which a building permit is issued on or after April 1, 1992. DEP prefers to have the tax triggered by the filing of a completed permit application; that will relieve pressure on them to issue a permit too quickly. They assure us that disputes over when an application is complete are not common. (Also see Lerch letter, circle 61.) Bill 34-90 as introduced took this approach, but staff had recommended that issuance of the permit be used so as to reduce potential litigation about when a given application was complete.

If this change is made, the Council should also consider advancing the effective dates from April 1, 1992 and 1993. Moving the trigger point from permit issuance to filing of an application would as a practical matter delay the application of the tax to a given building by about 3-6 months. If the Council wants to tax the same buildings that would pay under the current draft, the effective dates should be no later than January 1, 1992 and 1993. (However, see the next issue.)

In a related issue, the Planning Board has questioned whether those projects that received 6-month building permit extensions under Bill 27-91, which the Council enacted in July, should somehow be made subject to the tax. In our view, those projects should be covered only if their current building permit lapses and they have to apply for a new one; this is similar to the way such projects are treated for APF purposes.

8) Should economic indicators be used to determine when the tax should take effect?

Councilmember Praisner has proposed an amendment (circle B1) that would base the initial effective date of this tax on the achievement of a real estate recovery, as measured by certain economic indicators. (See background on indicators, circles B2-B4.) The Executive could modify the trigger points or substitute new indicators by a method 1 regulation, which is subject to Council approval.

The questions this amendment poses are:

-- Is this approach conceptually sound? Shouldn't the tax cover all construction as long as the funds are needed, instead of waiting until the real estate markets reach certain points? Any new construction arguably is, by the fact of its existence, economically able to contribute its share of infrastructure funding. The counterargument is that imposition of the tax before a recovery gains momentum will stifle investment; thus this approach triggers the tax when the market will bear it. A related concern is whether developers are more damaged by uncertainty and unpredictability in their financial planning; they can pay this tax, the argument goes, as long as they know about it long enough in advance.

-- If this approach is sound, are these the best indicators? Is the data they rely on accurate and timely? Councilmember Praisner has expressed an openness to alternative suggestions.

9) Administrative issues raised by the Executive's most recent memo:

a) Basements DEP expects a certain amount of tax avoidance by builders selling a house with an unfinished basement and then finishing it after the tax is paid. They propose taxing all basements at half their measured square footage. Staff is not sure this is necessary because the exemption for unfinished basements and attics exempts only those with headrooms lower than the minimum allowed in the Building Code; thus any exempt basement cannot legally be finished for human occupation. (Of course, many are anyway.)

b) Garages Louis D'Ovidio's memo argues that exempting garages gives an unfair advantage to buyers of larger houses. He may be right, but we agree with the Executive that it is too late in the process to change this.

c) Cost of Administration Staff agrees with the Executive that the cost of administering this tax should be taken from the tax itself. OMB estimates this cost at $350,000 the first year and $100,000 each later year. We included in the latest redraft an amendment to cover these costs (circle 9, lines 21 et seq).

Revenue Estimate

For the most recent revenue estimates from OMB, see circle 62.

charter group status
equity/distrib.
construction tax

how to collect & allocate
methods
reasons for implementing

implement
- policy
cohesive

- growth mgmt equity
(reduce competition for
certain l.u. types)
- equity for regional
responsibilities (homeless
- levelizing revenue
sources

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1. Implement policy
1e. Eliminate l.u. competition
2. Equitable allocation of Responsib
3. Levelize Revenue Sources