



# Statement of Revenue-Neutral Tax Rate: Questions and Answers

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In 2003 the General Assembly added subsection (e) to North Carolina General Statute (hereinafter G.S.) 159-11, which requires each taxing unit to publish a revenue-neutral property tax rate (“revenue-neutral rate”) as part of its budget for the fiscal year following the revaluation of its real property. Although the statute’s mandate is clear, it offers few details on how to accomplish the goal of producing an accurate revenue-neutral rate and explaining it to stakeholders. To assist local governments with this task, soon after the new requirement took effect the School of Government published *Local Finance Bulletin* No. 32, “Statement of Revenue-Neutral Tax Rate and Provision for Mid-Year Property Tax Rate Change.”<sup>1</sup> That bulletin provides guidance on how to calculate the revenue-neutral rate and suggests language for publishing that rate as part of the required annual budget message.

Since then, local governments have identified a number of potential pitfalls and areas of confusion regarding the revenue-neutral rate calculation. This bulletin uses a question-and-answer format to resolve some of these uncertainties and, hopefully, to promote a more consistent approach to the revenue-neutral rate calculation. We begin with a brief overview of the revenue-neutral rate and then offer our thoughts on ten frequently asked questions from local officials. We conclude with a discussion of the electronic template provided by the Local Government Commission for calculating the revenue-neutral rate on a four-year and eight-year revaluation cycle.

## Overview

A revenue-neutral rate provides taxpayers a benchmark against which they can compare a proposed post-revaluation tax rate. Although many local governments lower their tax rates after revaluations, their taxpayers may still face an effective tax increase depending on how far the

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1. Shea Riggsbee Denning and William C. Rivenbark. “Statement of Revenue-Neutral Tax Rate and Provision for Mid-Year Property Tax Rate Change,” *Local Finance Bulletin* No. 32 (November 2004).

rates are reduced. Publishing a statement of the revenue-neutral rate in the proposed budget for comparison purposes provides taxpayers with context for responding to their governing board's proposed tax rate for the coming fiscal year. G.S. 159-12(b) requires a public hearing before the governing board adopts the annual budget ordinance.

G.S. 159-11(e) defines the revenue-neutral rate as the rate that is estimated to produce revenue for the next fiscal year equal to the revenue that would have been produced for the next fiscal year by the current tax rate if no revaluation had occurred. G.S. 159-11(e) also instructs that the revenue-neutral rate is calculated as follows.

1. Determine a rate that would produce revenues equal to those produced for the current fiscal year.
2. Increase the rate by a growth factor equal to the average annual percentage increase in the tax base due to improvements since the last general revaluation.
3. Adjust the rate to account for any annexation, deannexation, merger, or similar event.

The calculation, on the surface, seems straight forward. A budget officer first determines a rate that when applied to the revalued tax base would produce a levy equal to the current fiscal year levy. That rate is then adjusted by the annual average tax base growth factor while controlling for unusual events, such as municipal annexations, that could skew that factor.

The devil is in the details, of course, and over the past five years the details of this seemingly straight-forward calculation have proven to be confusing and occasionally ambiguous. The question-and-answer section below addresses some of these areas of concern.

## Frequently Asked Questions—and Answers

### 1. For what taxes must a local government calculate a revenue-neutral rate?

A local government must calculate a revenue-neutral rate for each separate levy included in its budget ordinance.<sup>2</sup> For example, a county would publish revenue-neutral rates for its general property tax levy, for all service districts and rural fire districts, and for school supplemental taxes, while a municipality would publish revenue-neutral rates for its general property tax levy and for all service districts. One reason for this interpretation is to provide transparency for all taxes paid by a particular resident. A citizen who lives in a rural fire district, for example, would benefit from two revenue-neutral rates, one to analyze the impact of the revaluation on the county's general property taxes and one to analyze the impact of the revaluation on the fire district taxes.

### 2. Does a revenue-neutral rate calculation include only real property?

No, it includes all taxable property in the taxing jurisdiction. Although it is the revaluation of *real* property that triggers the obligation to publish a revenue-neutral rate, this calculation is based on *all* property: real property, personal property, registered motor vehicles, and public service company property. This is because a local government must determine a rate that would produce revenues equal to those produced for the current fiscal year. Revenues produced for the current fiscal year result from applying the tax rate against all property subject to the ad

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2. A. Fleming Bell, II, and David M. Lawrence, "Local Government and Local Finance," in *North Carolina Legislation 2003*, ed. William A. Campbell (Chapel Hill: UNC School of Government, 2004).

valorem tax, not just real property. A revenue-neutral rate calculated on real property alone would not be comparable to the actual property tax rate that is based on the total tax base.

**3. When calculating the average annual percentage increase in the tax base due to improvements since the last general revaluation, should a local government use the budgeted assessed value for each fiscal year?**

No. The assessed value used for budgetary purposes represents an estimate, which is used for estimating property tax revenue for the coming fiscal year. Local officials should use the final assessed value at fiscal year end, giving them the ability to calculate a growth factor based on actual figures rather than budgeted figures. For local governments that publish a comprehensive annual financial report (CAFR), this information can be found in the statistical section. Other local governments will need to contact their tax assessor for final figures. Of course, given that a revenue-neutral rate will need to be calculated before the end of the current fiscal year, the final assessed value for this year will not yet be available. This means the revenue-neutral rate calculation will require an estimate of the final assessed value for the current fiscal year. This estimate should be very accurate, however, because when it is made in May, all major changes to the tax base such as assessment appeals and motor vehicle registrations for the current fiscal year should be complete.

**4. Should a revenue-neutral rate be adjusted by a local government's tax collection rate?**

No. The revenue-neutral rate calculation focuses on the tax rate needed to produce the current fiscal year's tax levy from the newly revalued tax base, without regard for whether this levy was sufficient to satisfy budget needs for the current fiscal year. As discussed in the previous question, the current fiscal year's tax levy is the product of the current fiscal year's estimated final assessed value multiplied by the current tax rate. However, one reaches the same result if the revenue-neutral calculation begins with the current fiscal year's actual revenues instead of the actual tax levy. When the current fiscal year's actual revenues are divided by the actual collection rate, the resulting figure is the current fiscal year's actual tax levy. G.S. 159-13(b)(6) requires that the estimated percentage of property tax collections not be greater than the percentage of the levy actually realized in cash as of the June 30 during the preceding fiscal year. Therefore, one would return to a revenue-neutral rate that will produce the current fiscal year's tax levy when applied to the tax base after revaluation.

**5. Why is the average annual tax base growth factor part of the revenue-neutral rate calculation?**

Even in nonrevaluation years, most tax bases increase due to new construction and the accumulation of personal property by taxpayers. Absent a revaluation, the current tax base can be expected to increase by the average growth rate over the past several years. This means that even if the tax rate were kept constant, next year's tax levy would be larger than this year's tax levy. A revenue-neutral rate must be increased by an average annual growth factor to account for this expected natural growth in the tax base and tax levy. Remember that the revenue-neutral rate represents the tax rate that, when applied to the newly revalued tax base, is estimated to produce the same tax levy as would have been produced next year using the current year's tax rate if a revaluation had not occurred. If a revenue-neutral rate were not increased by an average annual growth factor of the tax base, the calculation would understate the tax levy that would be produced without the revaluation in the coming fiscal year.

## **6. How should a local government account for any annexations since the last revaluation?**

G.S. 159-11(e) requires a budget officer to adjust the growth factor to account for any annexation, deannexation, merger, or similar event. The most common adjustment occurs when a municipality annexes property. The reason for this requirement is to prevent the act of annexation from skewing the tax base growth rate from one fiscal year to another. Therefore, the value of the annexed property is backed out of the assessed value for the fiscal year when calculating the annual growth rate from the previous fiscal year. However, it is put back in the assessed value for the fiscal year when calculating the annual growth rate for the next fiscal year. Although the annexation itself should not be permitted to skew the annual growth rate, the annual growth rate should reflect growth within the annexed area once the property is annexed. See *Local Finance Bulletin* No. 32 for more information on this subject and for a sample calculation.

## **7. How should a local government account for the discovery of substantial taxable property since the last revaluation?**

Discoveries increase both the tax base and the current year tax levy. The former increase does not skew the revenue-neutral rate calculation; the latter increase may need to be taken into account so that the current year tax levy is not overstated. When calculating the average annual growth factor of the tax base since the last revaluation, adjustments must be made to account for any annexation, deannexation, merger, or similar event. Routine changes to the tax base, such as discoveries and assessment appeals, are part of the normal tax base growth process and should be included in the growth rate calculation regardless of their magnitude. Although a discovery bill can include up to six years of property taxes, the assessed value of the discovery is added to the tax base only once. No adjustments are required for the revenue-neutral rate calculation regardless of the scope of the discoveries involved.

This is not necessarily the case for the current year tax levy. If a budget officer calculates the current tax levy by multiplying the current tax rate by the current tax base, discoveries will not skew the calculation. However, if the budget officer obtains the current year's tax levy from the tax assessor, adjustments may be required. From a tax collector's perspective, the current year tax levy is the total billed and payable in the current fiscal year. This amount will include not only current year's taxes but also past taxes and penalties included on discovery bills. Because these amounts are one-time increases in the current year levy that will not be repeated in future years, they need to be removed from the levy figure obtained from the tax assessor before beginning a revenue-neutral rate calculation. Otherwise, both the target levy for the coming fiscal year and the revenue-neutral rate will be overstated.

## **8. What happens if the value of public service company property is reduced because a county's sales assessment ratio falls below 90 percent?**

This reduction must be accounted for in the growth factor calculation. In a process known as equalization, G.S. 105-284(b) requires that if the sales-assessment ratio for real property in a county falls below 90 percent in the fourth and seventh years following a revaluation of real property, the value of public service company property allocated to that county is reduced according to that percentage. This causes a reduction in the county's tax base but one that has nothing to do with the "normal" growth or contraction in the county's property value. Accordingly, this reduction in public service company property value must be backed out of the growth factor calculation in the same manner as an increase in property value caused by an annexation.

Counties on four-year revaluation cycles should escape equalization because they will revalue their property in the fourth year after revaluation—the first year that a sales-assessment study can trigger equalization. Counties on five-, six-, or seven-year revaluation cycles may be subject to equalization once, in the fourth year after revaluation. Counties on eight-year cycles could be subject to equalization twice, once in the fourth year after revaluation and again in the seventh year. If equalization occurs, a local government must add the lost value back to the tax base when calculating the annual growth rate between the fiscal year preceding the reduction and the fiscal year of the reduction. Doing so will prevent the equalization from skewing the annual growth rate.

For example, consider a county on an eight-year revaluation cycle. If the county's sales assessment ratio falls to 0.85 in year four, the state Department of Revenue would be forced to apply an equalization—in other words, a reduction—of public service company property assessed value. Assume that the county's allocated public service company property would have been \$60 million in year four but is instead \$51 million after the equalization. This \$9 million reduction in public service company property value should not be considered when calculating the tax base growth rate between year three and year four. Going forward, the \$9 million reduction should be applied to the tax base for future growth rate calculations. If the county suffers additional equalization in year seven, that additional reduction in public service company property would be ignored when calculating the tax base growth rate between year six and year seven. However, when calculating the tax levy for year seven, the final year of the revaluation cycle, the equalizations must be applied to the tax base so that the target revenue is accurate. For a detailed explanation of this example, please see Appendix A.

**9. If a municipality is located in more than one county, must it calculate a revenue-neutral rate whenever any one of those counties conducts a revaluation?**

Yes. G.S. 159-11(e) does not explicitly answer this question; instead it states simply that a revenue-neutral rate must be calculated “in each year in which a general revaluation of real property has been conducted, . . .” It seems appropriate to interpret this requirement as being triggered when *any* portion of a municipality's property is subject to a general revaluation, even if the reappraised property represents only a small percentage of the municipality's total taxable property.

This requirement could become burdensome for municipalities in multiple counties. Consider the city of High Point, unique among North Carolina municipalities because it sits in four counties: Davie, Forsyth, Guilford, and Randolph. If all four of those counties were on different four-year revaluation cycles, High Point would be required to calculate a revenue-neutral rate each time one of those counties conducted a revaluation of real property—in other words, every year. (Fortunately for High Point budget officials, this is not the case as of this writing. Davie County and Forsyth County are on identical four-year cycles that coincide with Randolph County's next six-year cycle.) When a multicounty municipality calculates a revenue-neutral rate because one of the counties in which it is located has conducted a revaluation, it should calculate the average growth rate for its tax base back to the most recent revaluation by *any* of the counties in which it is located, not back to the last revaluation by the county whose current revaluation triggered the calculation. Otherwise, the average annual growth rate would capture increases due to revaluations rather than only improvements and additions as intended by the statute.



## 10. Why will some taxpayers still face a tax increase if their local government adopts a revenue-neutral rate?

A revenue-neutral tax rate is intended to be revenue-neutral for the county as a whole, not for individual property owners. Therefore, some taxpayers may receive a higher tax bill (real and personal) even if the taxing unit adopts a revenue-neutral rate.

One reason that individual property owners may pay a higher tax bill (real and personal) is because the statute requires a taxing unit to increase its revenue-neutral rate by a growth factor equal to the average annual percentage increase in the tax base due to improvements since the last general revaluation.

Another reason is that a taxing unit's tax burden generally shifts toward real property and away from personal property in a revaluation year. Real property is valued at market value only in revaluation years, which in most counties occurs every four or eight years. When property values are rising, real property is assessed below its market value in the years following a revaluation. In contrast, personal property is valued at market value annually. As a result, personal property bears a greater proportion of the tax burden than does real property relative to market value. This imbalance is corrected in a revaluation year, when the tax value of real property is increased to market value. Because real property will now bear more of the tax burden, most real property owners will see a tax increase even if the county adopts a revenue-neutral rate. Personal property tax bills, however, will generally drop.<sup>3</sup>

Consider this example. In the year prior to revaluation, Carolina County's tax base—that is, the total assessed value of its taxable property—is \$100 million (75 percent of that amount or \$75 million is real property, 20 percent or \$20 million is personal property, and the remaining 5 percent or \$5 million is public service company property). After revaluation, the total assessed value of Carolina County's real property increases by 20 percent, from \$75 million to \$90 million. But, as is often the case, the value of the county's personal property and public service company property remains basically flat. Thus, after revaluation, the county's tax base is now \$115 million (78 percent of which is real property, 18 percent of which is personal property, and 4 percent of which is public service company property). Real property now represents 78 percent of the county's tax base, up from 75 percent prior to the revaluation. Because real property now bears a greater share of the tax burden, a Carolina County real property owner will see a tax increase even if the revenue-neutral rate is adopted, unless his or her real property increased in value substantially less than the 20-percent average countywide increase.

## Guidance from the Local Government Commission

In addition to this bulletin and *Local Finance Bulletin* No. 32, local budget officials can obtain assistance with their revenue-neutral rates from the Local Government Commission, which has created an Excel worksheet to help with the calculation. It can be found at [www.nctreasurer.com/dsthome/StateAndLocalGov/AuditingAndReporting/](http://www.nctreasurer.com/dsthome/StateAndLocalGov/AuditingAndReporting/) (click on “interim financial reporting worksheets”). This electronic template gives examples and calculates revenue-neutral rates for both four-year and eight-year revaluation cycles. While the template can be very helpful,

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3. The Forsyth County Tax Office has published an excellent and detailed discussion of this topic, available online at [www.co.forsyth.nc.us/Tax/reval.pdf](http://www.co.forsyth.nc.us/Tax/reval.pdf) (last visited June 22, 2009).

local officials should use caution when entering their data. The assessed value from the prior revaluation is needed, along with the assessed value for each fiscal year since. Note that the fiscal years are not sequential, but are entered twice. This is because that the annual growth rate between fiscal years should be treated as an independent event, allowing for adjustments to account for annexations or public service company property equalizations. The template also uses the tax levy to calculate a revenue-neutral rate rather than actual collections, as discussed in question four of this bulletin.

## Appendix A.

### Revenue-Neutral Property Tax Rate Example for an Eight-Year Cycle

Fiscal Year	Assessed Value (\$)	Growth Rate (%)	Tax Rate	Tax Levy (\$)	Notes
2000-1	1,100,000,000		0.650	7,150,000	A
2001-2	1,200,000,000	9.1	0.650	7,800,000	
2001-2	1,200,000,000				
2002-3	1,300,000,000	8.3	0.650	8,450,000	
2002-3	1,300,000,000				
2003-4	1,400,000,000	7.7	0.650	9,100,000	
2003-4	1,400,000,000				
2004-5	1,500,000,000	7.1			B
2004-5	1,491,000,000		0.650	9,691,500	C
2005-6	1,591,000,000	6.7	0.650	10,341,500	
2005-6	1,591,000,000				
2006-7	1,691,000,000	6.3	0.650	10,991,500	
2006-7	1,691,000,000				
2007-8	1,791,000,000	5.9			D
2007-8	1,785,000,000		0.650	11,602,500	E
2008-9	2,300,000,000		0.505	11,602,500	F

A. Revaluation year.

B. For the purposes of calculating the tax base growth rate between 2003-4 and 2004-5, the assessed value for 2004-5 ignores a \$9,000,000 reduction in public service company property resulting from the mandatory equalization when the county's sales assessment ratio fell to 0.85.

C. For the purposes of calculating the tax base growth rate between 2004-5 and 2005-6, the tax bases reflect the \$9,000,000 equalization in public service company property. The equalization is also reflected in the tax bases for the growth rate calculation between 2005-6 and 2006-7.

D. For the purposes of calculating the tax base growth rate between 2006-07 and 2007-8, the assessed value for 2007-8 ignores an additional \$6,000,000 reduction in public service company property resulting from the mandatory equalization when the county's sales assessment ration fell to 0.75.

E. For the purposes of calculating the tax levy for 2007-8, the tax base reflects the additional \$6,000,000 equalization in public service company property.

F. Revaluation year. The assessed value of \$2,300,000,000 represents the tax base after the reappraisal of real property. A tax rate of 0.505 would produce a tax levy equal to the tax levy in 2007-8. That rate is then adjusted by a growth factor of 7.3 percent, which is the average annual growth rate of assessed value since the last general reappraisal. The resulting revenue-neutral rate is 0.541 ( $0.505 \times 1.073$ ).

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