

# TAX NOTE: Likely Effect of Michigan Prop 2015-1 (“Road Tax” Proposal on May 5, 2015 Ballot) on Federal Income Taxes

*Revised and with a New Appendix*

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## TAX NOTE: Likely Effect of Michigan Prop 2015-1 ("Road Tax" Proposal on May 5, 2015 Ballot) on Federal Income Taxes

*Revised and with a New Appendix*

*Patrick L. Anderson  
Principal & CEO*

### *I. Executive Summary*

In late December 2014, the legislature and governor proposed a constitutional amendment that will be put before Michigan's voters on May 5th, 2015. Proposal 2015-1 would amend the constitution and trigger a package of related bills that would raise funds for road construction and maintenance, K-12 education and community colleges, and local governments, while restructuring several taxes.

**Effects Extend Beyond "Road Taxes".** Although described loosely as a "road tax" proposal, the effects of the proposal are far reaching, and complicated. Among these is a change in the amount and the type of registration tax levied on personal cars and other vehicles. This not only affects state tax revenue, it also raises federal tax liabilities for over one million Michigan residents.

This occurs because many Michigan taxpayers will no longer be able to claim a tax deduction they currently claim. In its current form, Michigan's vehicle registration tax is a deductible *ad valorem* personal property tax under section 164 of the Internal Revenue Code. The new tax would be an annual excise tax that remains the same regardless of the age or value of the vehicle. We conclude that such a tax would not meet the explicit *ad valorem* criteria set out in federal law for deductible taxes of this type.

**Change from *Ad Valorem* Tax Clearly Affects Deductibility.** In this revised edition, we cite and excerpt numerous authorities on this point, including the Internal Revenue Code, the Code of Federal Regulations, US Tax Court rulings, Michigan Attorney General Opinions, and other authorities. For example, one IRS Letter Ruling states: "Personal property taxes also may be deductible under §164(a), but §164(b)(1) requires a personal property tax be an ad valorem tax to be deductible;" the Michigan's Attorney General stated that "the ad valorem tax... is a tax of a fixed proportion of the value of the property with respect to which the tax is assessed," citing an 1899 Michigan Supreme Court decision; and US Tax Court decisions have stripped taxpayers in multiple other states of claimed deductions of fees and taxes that were determined not to be "ad valorem."

**Estimated Change in Federal Tax Liability.** We summarize a preliminary estimate of the effect of this loss of deductibility beginning in the year 2018 in this *Tax Note*. The key assumptions and calculations are as follows:

- Over 1.2 million Michigan residents itemized their deductions and claimed a deduction for property taxes, for tax year 2012. The property tax deduction was more popular than the mortgage interest and charitable deductions (both about 1.1 million claimants). Because many residents file as part of a household, this represents at least three million Michigan residents. The total deduction claimed for real and personal property taxes exceeded \$4.3 billion.

- Registration taxes collected by the State of Michigan exceeded \$768 million in 2013 (including registration plate fees for passenger vehicles, plus vehicle registration fees paid at purchase). There were 7.4 million passenger vehicles registered in 2013.
- We estimated the effect of a loss of deductibility using an apportionment of the property tax claimed in 2012; projecting that amount forward to 2018; and taking into account such factors as the alternative minimum tax (AMT) and the progressive rate structure of the federal income tax.
- Using this approach, we estimate that Michigan residents who itemize their deductions would lose the benefit of approximately \$410 million in itemized deductions. This would result in them paying approximately \$102 million in additional federal income taxes, if the proposal is adopted and other state and federal tax laws remain the same.
- This is a conservative estimate of the additional tax liability, which takes into account the effective limitations on deductions caused by the alternative minimum tax and the “Pease” provisions that have periodically been imposed. Furthermore, it considers only the foregone tax deduction on the former registration tax to be an implicit tax increase; the new registration tax would be significantly larger, and hence the implicit federal tax penalty on that larger amount would be greater than the amount estimated here.

**Summary: Effects on Tax Deductibility**

Affected Filers	1.2 m	
Affected Residents <sup>a</sup>	3+ m	
Registration Tax on Passenger Vehicles		\$768 m
Estimated Itemized Deduction		\$410 m
Effective Tax Rate on Disallowed Deductions <sup>b</sup>		25%
Total Lost Deduction		<u>\$102 m</u>

a. Many taxpayers file jointly and report multiple residents on one return.

b. After adjustment for AMT and “Pease” limitations. Statutory rates are 25%, 33%, 35%, and 39%.

**Limitations.** There are obvious limitations and cautions to our analysis, including the fact that this exercise requires the projection of both state *and* federal income tax laws into the future; and the underlying vehicle purchasing and ownership behavior of Michigan residents; and the likely changes in income over time; as well as the interaction of these with the progressive structure of U.S. income taxes. Furthermore, it is likely that federal tax laws, and state tax laws, will change between now and the time period we estimated. Our analysis is preliminary and based only on the data now available; we may revise it in the future. Finally, we recommend that concerned taxpayers consult with their own legal counsel regarding their personal tax situation.

*II. Deductibility of State & Local Property Taxes*

State and local property taxes can be deducted in arriving at taxable income for those who “itemize” their deductions. This includes personal property taxes. Both the authority to deduct, and the definition of personal property taxes are explicit in the Internal Revenue Code:

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) State and local, and foreign, real property taxes. (2) State and local personal property taxes.

...

For the purposes of this section:

(1) Personal property taxes: The term “personal property tax” means an ad valorem tax which is imposed on an annual basis in respect of personal property.<sup>1</sup>

This instruction is further repeated in IRS publication 503, which lists “personal property taxes” as a deductible, non-business tax. This same publication also lists categories of taxes that are non-deductible, including local benefit taxes such as special assessments, and warns taxpayers against deducting them.

### *Deductibility Limited to Ad Valorem Property Taxes*

The term “ad valorem” is the critical element in the definition of a personal property tax that is deductible under the Internal Revenue Code. It is one of the most well-defined concepts in tax law. For example:

The term ad valorem is derived from the Latin *ad valentiam*, meaning “to the value.” It is commonly applied to a tax imposed on the value of property. Real property taxes that are imposed by the states, counties, and cities are the most common type of ad valorem taxes. Ad valorem taxes can, however, be imposed upon personal property. For example, a motor vehicle tax may be imposed upon personal property, such as an automobile.

An article of commerce may be subjected to an ad valorem tax in proportion to its value, which is determined by assessment or appraisal.<sup>2</sup>

The Code of Federal Regulations, which governs the IRS in its application of tax laws, is similarly explicit regarding the *ad valorem* nature of deductible personal property taxes:

(c) *Personal property taxes.* The term “personal property tax” means an ad valorem tax which is imposed on an annual basis in respect of personal property. To qualify as a personal property tax, a tax must meet the following three tests:

(1) The tax must be ad valorem, that is, substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as ad valorem....<sup>3</sup>

### *III. Changes to the Michigan Vehicle Registration Tax*

**Change from an Ad Valorem to an Excise Tax.** Voter adoption of Proposal 2015-1 would trigger the effect of a set of statutes, including one (Public Act 470 of 2014, adopted by the legislature as HB 4630) that would change the current vehicle registration tax in the Motor Vehicle Code. The current statute levies a 0.5% tax on a base that declines over time. This is not exactly an *ad valorem* tax, but mimics one for at least several years, during which the base of the tax declines on a schedule that appears to match an optimistic view of the depreciation of passenger vehicles.

The new statute would levy a straightforward excise tax on the list price of the vehicle. The levy would be repeated annually without regard to the current value of the vehicle or its age.

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1. 26 USC sec 164.

2. West’s Law Dictionary; see “Appendix: Authorities, Deductible and Ad Valorem Taxes” on page 9.

3. CFR 1.164(a); for an extended excerpt with all three tests, see “Appendix: Authorities, Deductible and Ad Valorem Taxes” on page 9.

This is clearly not a deductible *ad valorem* personal property tax under the Internal Revenue Code. It is an excise tax on the initial sale price (or the “list price” as a proxy for it).

**Awareness of Possible Loss of Deductibility.** The change from an ad valorem tax to an excise tax was done in the open. For example, the House Fiscal Agency description of the bill that resulted in that statute states:

House Bill 4630 would implement increases in certain truck registration fees and increase vehicle registration tax revenue through eliminating the “depreciation” of ad valorem tax rates for passenger cars, vans, and light trucks.<sup>1</sup>

Furthermore, both legislative and executive officials have now publicly stated that they were aware of the issue of the loss of deductibility, and at least one legislative analysis mentioned the possibility.

#### *IV. Risks to Taxpayers*

**Basis for our interpretation.** This is our interpretation of the Internal Revenue Code with regard to a just-enacted law that has not, and may not, go into effect. Since the release of the original *Tax Note*, this interpretation was challenged publicly by at least one Michigan executive branch official, albeit in a manner that allowed for the possibility that the IRS might disallow deductions in the future, and which presumed that the legislature could then change the law to avoid such a disallowance.

In this revised *Tax Note*, we list multiple bases for this view:

- The Internal Revenue Code is explicit that only *ad valorem* personal property taxes are deductible.
- The Code of Federal Regulations is explicit that only *ad valorem* personal property taxes are deductible, and then goes on to state that non-ad valorem taxes are *not* deductible.
- The IRS has prosecuted cases involving taxpayers claiming personal property tax deductions in multiple states.
- The US Tax Court has upheld convictions and imposed back taxes on taxpayers who improperly claimed non-ad valorem “taxes” as deductions.
- Michigan law is also explicit on the nature of an ad valorem tax, and indeed the same General Property Tax Act imposes both the real and personal property tax.
- The nature and definition of an *ad valorem* tax is well established in law and practice. Legal dictionaries are clear on the definition, and that definition matches the one commonly seen in practical guidance, such as in the IRS instructions to income tax payers.
- The US Supreme Court and the Michigan Supreme Court have both rendered opinions distinguishing *ad valorem* taxes from other government charges, taxes, and fees.

To further support our opinion on this matter, we have included excerpts from these authorities, and further citations, in the revised *Tax Note* in “Appendix: Authorities, Deductible and Ad Valorem Taxes” on page 9.

**Risks to Michigan Taxpayers.** If the proposal does go into effect, taxpayers may face an awkward choice: continue deducting a tax that no longer technically fulfills the requirement, hoping the IRS will allow it; or choose not to deduct it and pay additional federal taxes. Those taking the former approach, of course, risk not only the cost of the repaying multiple years of disallowed deductions, but also penalties, interest, and interest on penalties.

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1. HFA analysis of Transportation Funding Package, December 2014.

Some taxpayers may hope that the IRS will just ignore the new law, or treat it as a minor adjustment in the state's taxing formula. The explicit and public description of the new law at the time of adoption makes it unlikely, in our opinion, that the IRS would simply ignore the change. Furthermore, the explicit nature of both the Internal Revenue Code and the Code of Federal Regulations make us confident that the new tax is not the same as the old tax, and that this opinion is the obvious and most logical one.

Indeed, the fact that the IRS has prosecuted cases involving relatively small amounts of disallowed personal property taxes (as little as \$25, in one matter) suggests that assuming the IRS will ignore or treat favorably the change in law would be reckless.

Finally, a review of the handful of published Tax Court cases involving disallowed personal property tax deductions indicates that the IRS often lumps together accusations of failure to pay income taxes involving multiple deductions and sources. Thus, a taxpayer selected for an examination ("audit") in the future for any number of reasons (or one that was randomly selected) could have the personal property tax deductions included as part of a basket of potential disallowances and related tax issues.

### *V. Michigan Taxpayers and Itemized Deductions*

In Michigan, 29% of federal income tax filers itemized in 2012. Over 90% of whom (26.6% of taxpayers) claimed an itemized deduction for state & local property taxes, according to IRS data analyzed by AEG. The average deduction was around \$950.

Separate data indicate that, in a typical year, among taxpayers with \$20,000 to \$50,000 in gross income, about a quarter itemize their deductions; for those with income between \$50,000 to \$100,000, the share jumps to over half; and for those with income over \$100,000, 90% itemize. The definition of "income" used in these calculations includes all salary, wages, interest, and other income for an entire taxpaying household. Thus, many taxpayers whose wages are below \$50,000 per year actually file taxes as a household with "adjusted gross income" of over \$100,000.

Estimating the possible loss of benefit from disallowed property tax deductions in Michigan, however, is quite complicated. Among other confusing factors, the AMT recaptures some share of itemized deductions; and in many years tax laws phase out the benefit of deductions to high-earning taxpayers. Furthermore, IRS source data lump together types of state & local taxes.

### *VI. Estimating the Cost to Michigan Taxpayers*

In this case, AEG estimated the potential loss using the following method: projecting forward from 2012 data the earnings, expenditures, and tax rates expected in 2018; changing the character of the Michigan auto registration tax from an ad valorem tax to an excise tax; and estimating the portion of registration taxes that are paid by those who itemize.

With these data, we created a simplified model of federal liabilities, and took into account the relative size of various tax deductions and their interaction, as well as the effect of the AMT. As a check on our analysis, we also created a representative household calculation that could be generalized to all Michigan residents. These two methods give similar results.

Note that this is a conservative estimate of the additional tax liability. In particular:

- It takes into account the effective limitations on deductions caused by the alternative minimum tax and the "Pease" provisions that have periodically been imposed.

- It considers only the foregone tax deduction on the former registration tax to be an implicit tax increase. The new registration tax would be significantly larger, and hence the implicit federal tax penalty on that larger amount would be greater than the amount estimated here.
- The implicit federal tax rate used for foregone federal income tax deductions was 25%. Even in 2015, this rate is smaller than the 28% rate faced by married-filing-jointly households with AGI over \$151,000, which would constitute a large share of the taxpayers subject to a lost deduction. The marginal rate increases to 33% for those MFJ taxpayers with AGI above \$230,000; 35% and 39.6% rates exist for AGI above that. Some portion of the difference between 25% and these higher rates is a method of compensating for the AMT and “Pease” factors.<sup>1</sup> However, the weighted-average effective rate on disallowed deductions is probably higher than 25%, even after AMT and Pease.
- A separately-calculated representative taxpayer model, if generalized to the entire resident population of Michigan, produces a higher estimate.

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1. “Pease” limitations, which have been introduced periodically in the Internal Revenue Code, reduce the deduction allowed against AGI for high-income taxpayers.

“Pease” limitations were reintroduced in 2013 and following years by the American Tax Relief Act of 2012

## VII. About the Author

**About Anderson Economic Group.** Anderson Economic Group is an economic research and consulting firm with offices in Michigan and Illinois. Their work has resulted in multiple public policy innovations in the State of Michigan including a change in the sales tax law (1998); reform of the tax reversion process (1999); creation of the industrial personal property tax credit (2005); the repeal of the SBT (2006); a wage increase for home help workers (2006); creation of the Michigan earned income tax credit (2008); and repeal of the item pricing law (2011).

**About Patrick L. Anderson.** Mr. Anderson founded Anderson Economic Group in 1996, and serves as a Principal and Chief Executive Officer in the company.

Anderson Economic Group is one of the most recognized boutique consulting firms in the United States, and has been a consultant for states such as Michigan, Kentucky, North Carolina, Wisconsin and Ohio; the Province of Ontario; manufacturers such as General Motors, Ford, DaimlerChrysler, Honda; retailers such as Meijer; telecommunications companies such as AT&T; utilities like ITC; the University of Michigan, University of Chicago, and other colleges; and the franchisees of Anheuser-Busch, Molson, Coors, Miller, Harley-Davidson, Mercedes-Benz, Suzuki, Cadillac, Chevrolet, Ford, Lincoln, and Avis products.

Mr. Anderson has written over 100 published works, including the just-released *Economics of Business Valuation* from Stanford University Press. Three of his articles have each been awarded for outstanding writing from the National Association of Business Economics. Before founding Anderson Economic Group, Mr. Anderson was the deputy budget director for the State of Michigan under Governor John Engler, and Chief of Staff for the Michigan Department of State.

The Michigan Chamber of Commerce awarded Mr. Anderson its 2006 Leadership Michigan Distinguished Alumni award for his civic and professional accomplishments. The University of Michigan Ford School of Public Policy awarded him its Neil Staebler Award for civic participation in 2014.

**Acknowledgements.** The author wishes to acknowledge the assistance of Alex Rosaen, director of public policy, and Traci Taylor, senior analyst, at Anderson Economic Group; and also the comments and discussion from the group of experts assembled to review the proposal in late December 2014.

**About Tax Notes.** *Tax Notes* are summaries of tax policy issues that are made available to the public without charge by Anderson Economic Group experts. They are often informed by research and analysis done for other purposes, including other AEG clients, and are oriented toward a general audience. The views expressed in these publications are, of course, those of the authors and not of any AEG clients.

Please note that tax laws and economic conditions can, and do, change regularly. Therefore, we recommend that concerned taxpayers retain professional assistance regarding their specific business, tax, or investment situation.

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## VIII. Appendix: Authorities, Deductible and Ad Valorem Taxes

### INVESTOPEDIA

#### *Definition of 'Ad Valorem Tax'*

A tax based on the assessed value of real estate or personal property. Ad valorem taxes can be property tax or even duty on imported items. Property ad valorem taxes are the major source of revenue for state and municipal governments.

Municipal property ad valorem taxes are also known as “property taxes”.

#### *Investopedia Explains 'Ad Valorem Tax'*

The phrase ad valorem is Latin for “according to value”. In the case of municipal property taxes, property owners have their property assessed on a periodic basis by a public tax assessor. The assessed value of the property is then used to compute an annual tax, which is levied on the owner by his or her municipality. Ad valorem taxes are incurred through ownership of an asset, in contrast to transactional taxes, such as sales taxes, which are incurred only at the time of transaction.<sup>1</sup>

### WEST'S ENCYCLOPEDIA OF AMERICAN LAW

#### *Ad Valorem*

##### *According to value*

The term ad valorem is derived from the Latin *ad valentiam*, meaning “to the value.” It is commonly applied to a tax imposed on the value of property. Real property taxes that are imposed by the states, counties, and cities are the most common type of ad valorem taxes. ad valorem taxes can, however, be imposed upon Personal Property. For example, a motor vehicle tax may be imposed upon personal property such as an automobile.

An article of commerce may be subjected to an ad valorem tax in proportion to its value, which is determined by assessment or appraisal.<sup>2</sup>

### BLACK'S LAW DICTIONARY

#### *What is Ad Valorem?*

According to value. Duties are either ad valorem or specific; the former when the duty is laid in the form of a percentage on the value of the property; the latter where it is imposed as a fixed sum on each article of a class without regard to its value. The term ad valorem tax is as well defined and fixed as any other used in political economy or legislation, and simply means a tax or duty upon the value of

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1. <http://www.investopedia.com/terms/a/advaloremntax.asp>; retrieved Jan 2015.

2. West's Encyclopedia of American Law, edition 2. (2008). Retrieved January 29 2015 from <http://legal-dictionary.thefreedictionary.com/ad+valorem+tax>.

the article or thing subject to taxation. *Bailey v. Fuqua*, 24 Miss. 501; *Piugree v. Auditor General*, 120 Mich. 95, 78 N. W. 1025, 44 L. It. A. 079.<sup>1</sup>

## MICHIGAN ATTORNEY GENERAL OPINION

In *Pingree v Auditor General*, 120 Mich 95; 78 NW 1025 (1899), the Court set forth the general rule to determine whether taxes are specific or ad valorem. In that decision, the Court recognized that specific taxes are of a fixed amount by the head or number, or by some standard of weight or measurement, and require no assessment other than a listing or classification of the subjects to be taxed. The fact that in imposing a specific tax, the value of the thing taxed is taken into consideration in determining the amount of it, does not change the nature of the tax. The ad valorem tax, on the other hand, is a tax of a fixed proportion of the value of the property with respect to which the tax is assessed, and requires the intervention of assessors or appraisers to estimate the value of such property before the amount due from each taxpayer can be determined.<sup>2</sup>

## US SUPREME COURT PRECEDENTS

*United States v. County of Allegheny*, 322 U.S. 174 (1944)

**It is not contended that the scheme of taxation employed by Pennsylvania is anything other than the old and widely used ad valorem general property tax. This taxation plan involves the identification and valuation of the variable individual holdings to be taxed, commonly called the assessment, the application of a uniform rate calculated on the need for public revenues, and the collection, in default of payment, by distraint and sale of the property assessed and taxed.** This form of taxation is not regarded primarily as a form of personal taxation, but rather as a tax against the property as a thing. Its procedures are more nearly analogous to procedures in rem than to those in personam. While personal liability for the tax may be and sometimes is imposed, the power to tax is predicated upon jurisdiction of the property, not upon jurisdiction of the person of the owner, which often is lacking without impairment of the power to tax. In both theory and practice, the property is the subject of the tax, and stands as security for its payment. [emphasis added]

The Pennsylvania statutes embody this scheme of taxation. They are a century old. The basic provision reads:

“The following subjects and property shall... be valued and assessed, and subject to taxation.”

Taxes are “declared to be a *first lien on said property*” (emphasis supplied). It is only under these legislative provisions that the tax in question is laid.

[Footnotes omitted].

*City of Detroit v. Murray Corp.*, 355 U.S. 489 (1958)

**Syllabus.** Michigan municipalities assessed a tax against a subcontractor under a prime contract between the United States and two other private corporations for the manufacture of airplanes and airplane parts. The tax was based in part on the value of materials and work in process actually in the pos-

1. Definition of AD VALOREM (Black's Law Dictionary); retrieved Jan. 2015.

2. OAG no. 5737, July 1980; retrieved from [www.ag.state.mi.us](http://www.ag.state.mi.us), Jan. 2015.

session of the subcontractor but legal title to which had paid to the United States under the terms of the subcontract upon the making of partial payments therefor.

Held: this tax does not infringe the Federal Government's constitutional immunity from state taxation or discriminate against the Government, its property or those with whom it does business.

**Excerpt.** The Court found that the Pennsylvania scheme of taxation was, in fact, “the old and widely used *ad valorem* general property tax.” 322 U.S. at 322 U. S. 184. As we are told by the Court in the present case,

“Reviewing all the circumstances, the Court [in Allegheny] concluded that the tax was simply and forthrightly imposed on the property itself, not on the privilege of using or possessing it.”

But this is so *a fortiori* in the circumstances of Nos. 18 and 36 now before us. Surely the detailed analysis of my brother WHITTAKER of “the terms of the contract and the rights and obligations of the parties under it,” in relation to the taxing system of Michigan, demonstrates, if anything is demonstrable in the law, that the tax imposed has all the incidents of a general *ad valorem* property tax, and that it has them to a more conclusive degree than was true of the tax levied by Pennsylvania in the Allegheny case.

See also: *United States v. City of Detroit*, 355 U.S. 466 (1958);  
*United States v. Allegheny County*, 322 U. S. 187 (1944).

## MICHIGAN LAW

### *General Property Tax (Act 206 of 1893)*

Sec. 1.

That all property, real and personal, within the jurisdiction of this state, not expressly exempted, shall be subject to taxation.

Sec. 27a. [personal property]

(1) Except as otherwise provided in this section, property shall be assessed at 50% of its true cash value under section 3 of article IX of the state constitution of 1963.<sup>1</sup>

### *Glen Steil Revenue Sharing (Act 140 of 1971)*

Sec. 4.

(1) “Local property taxes” means *ad valorem* property taxes levied by a city, village, or township.<sup>2</sup>

### *Prohibited Taxes by Cities and Villages (Act 243 of 1964)*

The Act prohibits cities and villages from levying anything other than an *ad valorem* property tax unless specifically authorized by law.<sup>3</sup>

### *Michigan Treasury: “Ad Valorem Property Tax Report”*

1. MCL 211.1, 211.27a; retrieved from Michigan legislature site, Jan 2015.

2. MCL 141.904 et seq.; retrieved from Michigan legislature site, Jan 2015.

3. MCL 141.91.

This annual report shows the calculation of “ad valorem” taxes as a rate times a taxable value, where the taxable value changes from year to year. Taxable value is based on the market value (as equalized and with annual changes limited by Prop A of 1994). Both real and personal property are included. As noted in the preface to the report:

On March 15, 1994, Michigan voters adopted Proposal A. Prior to Proposal A, State Equalized Value (SEV) was used in calculating property taxes. As established by Proposal A, beginning with the 1995 tax year, and continuing through the current tax year, TAXABLE VALUE is used as the base for calculating property taxes and is used instead of SEV throughout this book.

The information in this book is based on the combined total TAXABLE VALUE of all classes of property, real and personal.

According to the 2013 report, the State and local governments collected \$12.8 billion in 2013. The state alone collected \$1.8 billion in state education tax. The tax collected changes each year, as the tax base (the valorem of the ad valorem) changes each year.<sup>1</sup>

## INTERNAL REVENUE SERVICE

*Letter Ruling 2012-0018 (March 2012)*

[From Office of the Chief Counsel]

Dear [redacted]:

I am responding to your letter to the Chief Counsel dated December 8, 2011, in which you asked for clarification of the Internal Revenue Service's views on whether real property taxes must be assessed on an ad valorem basis to be deductible for federal income tax purposes.

...

Section 164(a)(1) of the Internal Revenue Code permits a deduction for real property taxes, but does not define what constitutes a real property tax. Personal property taxes also may be deductible under § 164(a), but § 164(b)(1) requires a personal property tax be an ad valorem tax to be deductible. The Code does not explicitly require the same for real property taxes.

...

## CODE OF FEDERAL REGULATIONS

*26 CFR 1.164-1 et. seq*

§ 1.164-1 Deduction for taxes.

(a) In general. Only the following taxes shall be allowed as a deduction under this section for the taxable year within which paid or accrued, according to the method of accounting used in computing taxable income:

- (1) State and local, and foreign, real property taxes.
- (2) State and local personal property taxes.

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1. Report retrieved from Michigan Treasury site at: [http://michigan.gov/documents/treasury/2013\\_625\\_Ad\\_Valorem\\_Tax\\_Levy\\_Report\\_452269\\_7.pdf](http://michigan.gov/documents/treasury/2013_625_Ad_Valorem_Tax_Levy_Report_452269_7.pdf), Jan 2015.

- (3) State and local, and foreign, income, war profits, and excess profits taxes.
- (4) State and local general sales taxes.
- (5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.

...

§ 1.164-3 Definitions and special rules.

For purposes of section 164 and § 1.164-1 to § 1.164-8, inclusive—

(a) *State or local taxes.* A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

(b) *Real property taxes.* The term “real property taxes” means taxes imposed on interests in real property and levied for the general public welfare, but it does not include taxes assessed against local benefits. See § 1.164-4.

**(c) *Personal property taxes.* The term “personal property tax” means an ad valorem tax which is imposed on an annual basis in respect of personal property. To qualify as a personal property tax, a tax must meet the following three tests:**

**(1) The tax must be ad valorem—that is, substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as ad valorem.** For example, a motor vehicle tax based on weight, model year, and horsepower, or any of these characteristics is not an ad valorem tax. However, a tax which is partly based on value and partly based on other criteria may qualify in part. For example, in the case of a motor vehicle tax of 1 percent of value plus 40 cents per hundredweight, the part of the tax equal to 1 percent of value qualifies as an ad valorem tax and the balance does not qualify.

**(2) The tax must be imposed on an annual basis,** even if collected more frequently or less frequently.

**(3) The tax must be imposed in respect of personal property.** A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. Thus, for taxable years beginning after December 31, 1963, **state and local taxes on the registration or licensing of highway motor vehicles are not deductible as personal property taxes unless and to the extent that the tests prescribed in this subparagraph are met.** For example, an annual ad valorem tax qualifies as a personal property tax although it is denominated a registration fee imposed for the privilege of registering motor vehicles or of using them on the highways. [emphasis added]

...

§ 1.164-4 Taxes for local benefits.

(a) So-called taxes for local benefits referred to in paragraph (g) of § 1.164-2, more properly assessments, paid for local benefits such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied are not deductible as taxes. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. **The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction.** Assessments under the statutes of California relating to irrigation, and of Iowa relating to drainage, and under certain statutes

of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes.<sup>1</sup> [emphasis added]

## U.S. TAX COURT RULINGS

### *Carl & Carol Naso v. Commissioner of IRS (AZ)*

T.C. Summary no. 2010-39

Taxpayer deducts \$231 in “personal property taxes” based on an accountant’s allocation of a transaction privilege tax paid in conjunction with the purchase of the house and calculated on the basis of retail sales price. IRS disallows deduction for sales taxes, and then also disallows deduction of personal property taxes, stating “petitioners are deemed to have conceded this issue.”

Excerpt:

Deductions are strictly a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to the deductions claimed. Rule 142(a); *INDOPCO, Inc. v. Commissioner*...

### *Ronna Robertson v. Commissioner of IRS (CA)*

T.C. Memo no. 2000-100.

Petitioner deducted \$268 and \$207 in fees to the California DMV for registration and licensing of four different vehicles. Petitioner also contends that smog certification and driver’s license fees are deductible. Respondent concedes that registration fees are ad valorem personal property taxes. Court rules that no drivers license or smog fees are deductible, and only two of the four cars are actually owned by the taxpayer and hence deductible. Court describes difference between *ad valorem* taxes and flat registration fees, saying only the former are deductible as personal property taxes. Court allows deduction of real property taxes.

Excerpt:

Moreover, a taxpayer who is claiming a deduction bears the burden of substantiating the amount and purpose of the item claimed. See *Hradesky v. Commissioner*, 65 T.C. 87, 90 (1975), *affd. per curiam* 540 F.2d 821 (5th Cir. 1976); sec. 1.6001-1(a), *Income Tax Regs.*  
...

#### C. Personal Property Taxes

Section 164(a)(2) permits deductions for State and local property taxes. Under section 164(b)(1), property taxes are defined as an ad valorem tax that is imposed on an annual basis in respect of personal property. Thus, an ad valorem auto license fee is deductible as a personal property tax, whereas an annual flat registration fee is not deductible. See sec. 1.164(a)(2); *Mann v. Commissioner*, T.C. Memo. 1975-74; sec. 1.164-3(c), *Income Tax Regs.*

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1. Retrieved from <http://www.law.cornell.edu/cfr/text/26/1.164-4>, Jan 2015.

*Michael Boltinghouse v. Commissioner of IRS (NC)*

T.C. Memo 2007-324

Petitioner deducted itemized deductions of \$12,999, in a number of categories, including personal property taxes, and provides a certificate reflecting a \$25 vehicle registration fee. Tax Court disallows the deduction because “petitioner has not provided any evidence that any of this fee is an ad valorem fee as opposed to an annual flat fee, and therefore it is not deductible.”

Excerpt:

Section 164(a) allows a taxpayer deductions for State and local income taxes, real property taxes, and personal property taxes. On the proposed Form 1040, petitioner seeks to deduct \$911 for State and local taxes paid, of which respondent has conceded \$861.33.

Of the remaining \$49.67, petitioner claims he is entitled to a deduction of \$25 for vehicle registration fees and has provided a certificate reflecting this amount. Section 164(b)(1) defines a “personal property tax” as an annual ad valorem tax that is imposed upon personal property. Petitioner has not provided any evidence that any of this fee is an ad valorem fee as opposed to an annual flat fee, and therefore it is not deductible. See N.C. Gen. Stat. sec. 20-87(5) (2005).

*Sandy Lake (TX)*

T.C. Memo 1997-295.

Petitioner wishes to declare a “rollback tax” (a kind of ad valorem property tax) to be an expense that can be expensed against portfolio income, rather than deducted as a property tax. Tax Court disagrees and re-states the definitions of “ad valorem” and “property tax.”

Excerpt:

An ad valorem tax is one which is imposed on the basis of the value of the article or thing taxed. *Waxenberg v. Commissioner*, supra at 604. The rollback tax, like the tax on the open-space assessed value of the Property that petitioner concedes is a real property tax, is based on the assessed value of the Property, albeit it is calculated using the market value of the land rather than the open-space assessed value...

Based on the above discussion, we hold that the Texas rollback tax is a tax imposed on an interest in real property, and is therefore, in both substance and form, a real property tax within the meaning of section 164(a)(1) and, by cross-reference, the parenthetical provision contained in the last sentence of section 164(a)(1). See *Waxenberg v. Commissioner*, supra at 603-604 (quoting *City of De Land v. Florida Public Service Co.*, 161 So. 735, 738 (Fla. 1935)) (“[I]f the tax is computed upon the valuation of the property, and assessed by assessors, \* \* \* although privileges may be included in the valuation it is considered a property tax.”) (emphasis added); see also *Polakis v. Commissioner*, 91 T.C. 660, 665 (1988).