Revenue and Transportation Interim Committee

58th Montana Legislature

PO BOX 201706
Helena, MT 59620-1706
(406) 444-3064
FAX (406) 444-3036

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TO: Revenue and Transportation Interim Committee

FROM: Jeff Martin, Legislative Research Analyst

SUBJECT: Taxation of Class Eight Business Equipment and Other Policy Considerations

At the February 13, 2004, Revenue and Taxation Interim Committee meeting, staff outlined several topics to consider related to the taxation of class eight business equipment. The purpose of this memorandum is to compare the relative tax burden of commercial and industrial real and personal property in Montana with 12 other states; to review the relative importance of class eight property by county; to provide an example of the revenue impact of "pulling" the class eight exemption "trigger" on class twelve railroad and airline property; to discuss the feasibility of combining class eight business equipment with class four land and improvements; and to present alternatives to the calculation of the class eight trigger. Legislative Fiscal Division staff will present additional information as noted on the agenda for the April 30 meeting.

Interstate Comparisons of Effective Tax Rates on Commercial and Industrial Property
The Minnesota Taxpayers Association has conducted a series of studies that compare the relative tax burdens of various classes of property across the United States for property taxes payable in 1995, 1998, 2000, and 2002.[1] Each study calculated the effective tax rates of four classes of property: residential, commercial, industrial, and apartments. Comparisons were made for the largest city in each state and a "typical" rural area.

Each study assumed that:

> the "true market value" of each of several parcels of property is the same in all 51 locations studied. Because the "assessed value" of property varies, sometimes significantly, from state to state, our tax calculations necessarily account for the effects of local assessment practices, as well as statutory tax provisions. Each hypothetical property includes assumptions about personal property as well as real property. Effective tax rates--that is, total tax divided by total value--are presented in rank order.

Comparisons in this memorandum focus on effective tax rates for commercial and industrial

[1]Minnesota Taxpayers Association, 50-State Property Tax Comparison Study, Payable years 1995 (June 1996), 1998 (January 1999), 2000 (January 2001), and 2002 (May 2003). The studies have been conducted in cooperation with the National Taxpayers Conference. The 2002 study was conducted by the Minnesota Center for Public Finance Research.

property located in urban and rural areas in 11 western states and North Dakota and South Dakota. For both commercial property and industrial property , the studies determined the effective tax rates for land and improvements with a true market value of $100,000, $1 million, and $25 million. The studies made specific assumptions about the proportion of personal property associated with each example. Effective tax rates in this memorandum are shown for commercial and industrial property with market values as follows:

Commercial property
- land and improvements, $1,000,000
- fixtures, $20,000

Industrial property
- land and improvements, $1,000,000
- machinery and equipment, $500,000
- inventories, $400,000
- fixtures, $100,000

For each study, the true market value of real property is adjusted by local sales assessment ratios. Sales assessment ratios are a measure of the quality of assessment for property tax purposes. If a sales assessment ratio is below 100%, the property is underassessed. For example, if the sales assessment ratio in a given location is 93%, then the assessed value of $1 million of property is $930,000 for property tax purposes. Property taxes were calculated as follows:

> Net property taxes = true market value **x** sales assessment ratio **x** statutory rate (or assessment rate) **x** mill levy

Effective tax rates are calculated by dividing taxes paid by total true market value (including the value of exempt property) of real and personal property.[2] [3]

Table 1 shows for each comparison the state, the urban and rural city, the mill levy (sales ratios are in parentheses), the statutory tax rate, property subject to taxation, and exemptions. Of the comparison states, only North Dakota and South Dakota do not tax personal property. All of the comparison states exempt inventories, but the value of inventories is included in the calculation of the effective tax rate. Arizona exempts the first $50,000 (adjusted for inflation) of personal property owned by a taxpayer.[4]

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[2]The discussion of the methods and assumptions is taken from Appendix A of the 2002 study.

[3]The effective tax rates calculated for Montana in the Minnesota studies will be lower than those calculated by the Montana Department of Revenue in the biennial reports because the Minnesota studies include the value of exempt property.

[4]In 1996, the voters in Arizona approved a constitutional referendum allowing the exemption of the first $50,000 of market value of personal property. The exemption is adjusted for inflation each year; the amount exempt in tax year 2002 is $54,367. An Arizona Court of Appeals found the statute enacting the exemption in violation of the constitutional provision authorizing the exemption for each taxpayer rather than for each business location (Maricopa County v. Kinko's, Inc.). The 2004

Table 1: Summary of Selected Property Tax Provisions by State, Payable Year 2002				
State	Mill Levies (Sales Ratios)	Statutory Rates	Tax Basis	Exemptions
Arizona	Phoenix--137.296 (84.5%) Cottonwood--82.6217 (74%)	Homesteads--10% Comm/Indus--25%	Real and personal	First $50,000 of business equip. Inventories
California	Los Angeles--12.5 (100%) Red Bluff--10.0 (100%)	All property--100%	Real and personal	Inventories
Colorado	Denver--58.74 (99.9%) Walsenburg--74.96 (100.9%)	Homesteads--9.15% All other property--29%	Real and personal	Inventories
Idaho	Boise--17.28 (88%) St. Anthony--16.89 (101.6%)	All property--100%	Real and personal	Inventories
Montana	Billings--560.33 (81%) Choteau--532.98 (91%)	Real--3.46% Personal--3%	Real and personal	Business real--13% of market value Inventories
Nevada	Las Vegas--32.55 (97.1%) Fallon--34.70 (98.9%)	All property--35%	Real and personal	Inventories
New Mexico	Albuquerque (90%) Homestead--38.6 Comm/Indus--45.66 Clayton (87%) Homestead--22.09 Comm/Indus-24.86	All property--33.33%	Real and personal	Inventories
North Dakota	Fargo--493.22 (90.8%) Bottineau--445.03 (100.9%)	Homestead--4.5% Comm/Indus--5.0%	Real	Personal property except utilities
Oregon	Portland--21.21 (100%) Coos Bay--16.94 (100%)	All property--100%	Real and personal	Inventories
South Dakota	Sioux Falls (92.8%) Homestead--18.29 Comm/Indus.--25.76 Humboldt (92.8%) Homestead--20.82 Comm/Indus-28.29	All property--100%	Real	Personal property except utilities and railroads
Utah	Salt Lake--14.36 (100.2%) Richfield--13.61 (103.2%)	All property--100%	Real and personal	Inventories
Washington	Seattle--10.66 (90.6%) Rock Island--14.12 (93.9%)	All property 100%	Real and personal	Inventories
Wyoming	Cheyenne--76 (100%) Lovell--67.56 (100%)	Homestead/Comm--9.5% Industrial--11.5%	Real and personal	Inventories

Source: 50-State Property Tax Comparison Study, Payable Year 2002, Appendix B, Minnesota Center for Public Finance Research, May 2003.

Arizona Legislature is considering another constitutional referendum (Senate Concurrent Resolution 1020) that would, if approved by the electorate, exempt personal property from taxation. The exemption would not apply to mining, utility, railroad, and airline personal property.

Table 2 shows the effective tax rates and relative rankings for industrial real and personal property.[5] In 1995, Montana had the third highest effective tax rate on industrial property in both the urban and rural areas. In that year, the statutory tax rate on real property was 3.86% of market value and the tax rate on personal property was 9%. In 1998, the effective tax rate on industrial property in Billings fell to 1.61% and was below the national average, but still above the regional average.[6] The statutory tax rate on real property was 3.83% of market value,[7] and the tax rate on personal property was 7%.

Table 2: Estimated Effective Tax Rates for Industrial Real and Personal Property--Payable Year 1995, 1998, 2000, 2002

	1995				1998			
State	Urban	Rural	Rank-U	Rank-R	Urban	Rural	Rank-U	Rank-R
Arizona	2.63	2.01	1	1	2.74	NA	1	NA
Colorado	1.87	1.94	2	2	1.65	NA	2	NA
Montana	**1.86**	**1.86**	**3**	**3**	**1.61**	**NA**	**3**	**NA**
Idaho	1.54	1.51	4	4	1.40	NA	4	NA
Oregon	1.24	1.21	5	6	1.27	NA	5	NA
Utah	1.22	1.11	6	7	1.13	NA	7	NA
South Dakota	1.14	1.35	7	5	1.18	NA	6	NA
North Dakota	1.07	0.95	8	9	1.10	NA	8	NA
New Mexico	0.97	0.58	9	13	1.00	NA	9	NA
Washington	0.85	1.04	10	8	0.91	NA	10	NA
California	0.84	0.82	11	10	0.84	NA	11	NA
Wyoming	0.74	0.63	12	12	0.73	NA	13	NA
Nevada	0.65	0.66	13	11	0.82	NA	12	NA
Regional Average	1.28	1.20			1.26	NA		NA
U.S. Average	1.78	1.40			1.75	NA		NA

[5]The effective tax rates for industrial property valued at $100,000 in Arizona are lower than shown in the table and are higher for property valued at $25 million. The differences are because of the exemption for the first $50,000 of personal property.

[6]The Minnesota Taxpayers Association did not include rural areas in the 1998 publication.

[7]Senate Bill No. 195 (Ch. 463, L. 1997) provided a phased-in increase in valuation and a phased-in reduction in the class four tax rate to offset the impacts of reappraisal that went into effect in tax year 1997.

Table 2: Estimated Effective Tax Rates for Industrial Real and Personal Property--Payable Year 1995, 1998, 2000, 2002

	2000				2002			
State	Urban	Rural	Rank-U	Rank-R	Urban	Rural	Rank-U	Rank-R
Arizona	2.98	1.75	1	2	2.87	1.56	1	2
Oregon	1.63	1.47	2	4	1.70	1.36	2	4
Colorado	1.53	1.76	3	1	1.36	1.75	3	1
Idaho	1.44	1.11	4	5	1.28	1.38	4	3
South Dakota	1.30	1.47	5	3	1.20	1.31	5	5
Utah	1.14	1.03	6	7	1.13	1.11	8	7
North Dakota	1.10	1.00	7	9	1.06	1.07	9	9
Montana	**1.01**	**1.04**	**8**	**6**	**1.19**	**1.21**	**6**	**6**
California	1.00	0.80	9	11	1.00	0.80	10	11
New Mexico	1.00	0.63	9	12	1.14	0.61	7	13
Washington	0.91	1.01	11	8	0.80	1.08	12	8
Nevada	0.87	0.93	12	10	0.90	0.97	11	10
Wyoming	0.69	0.60	13	13	0.70	0.62	13	12
Regional Average	1.28	1.12			1.26	1.14		
U.S. Average	1.73	1.43			1.69	1.31		

Rankings determined by Montana Legislative Services Division. NA means not available.
Source: 50-State Property Tax Comparison Study, Payable Years 1995, 1998, 2000, 2002, Minnesota Taxpayers Association.

In 1999, the Montana Legislature made significant changes to the property tax system. Senate Bill No. 200 (Ch. 285, L. 1999) reduced the tax rate on personal property from 6% to 3%. Senate Bill No. 184 (Ch. 584, L. 1999) provided a progressive reduction in the class four tax rate (from 3.63% in tax year 2000 to 3.46% in tax year 2002) and phased in exemption amounts for residential and commercial property. The legislation also revised the phasein of the 1997 reappraisal in Senate Bill No. 195 (Ch. 463, L. 1997) from 2% a year to 25% a year (with a 6-year phasein for subsequent reappraisals). As a result, the effective tax rate in 2000 on industrial property in Billings was significantly lower than in 1998 and was below the regional and national averages. In 2000, Montana ranked below North Dakota and South Dakota, both of which exempt personal property. However, in 2002, the effective tax rates in Montana increased because of higher mill levies. The effective tax rate in Billings was below the national and regional averages, but the effective tax rate in Choteau was above the regional average.

Table 3 shows similar information for commercial property. In almost every instance, the effective tax rate for commercial property is higher than industrial property. One reason for the difference is including exempt inventories in total market value when calculating effective tax rates for industrial property. In some instances, the effective tax rates in rural areas are higher than urban areas. The higher effective tax rate may be because of higher mill levies or higher sales ratios.

Table 3: Estimated Effective Tax Rates for Commercial Real and Personal Property--Payable Years 1995, 1998, 2000, 2002

	1995				1998			
State	Urban	Rural	Rank-U	Rank-R	Urban	Rural	Rank-U	Rank-R
Arizona	3.29	2.39	1	2	3.19	NA	1	NA
Colorado	2.33	2.41	2	1	2.02	NA	2	NA
Idaho	1.90	1.83	3	5	1.72	NA	5	NA
South Dakota	1.90	2.25	3	3	1.98	NA	3	NA
Montana	**1.85**	**1.84**	**5**	**4**	**1.65**	**NA**	**6**	NA
North Dakota	1.79	1.59	6	6	1.83	NA	4	NA
Oregon	1.54	1.50	7	7	1.45	NA	7	NA
Utah	1.49	1.37	8	8	1.40	NA	8	NA
New Mexico	1.17	0.71	9	12	1.21	NA	9	NA
California	1.05	1.02	10	10	1.05	NA	11	NA
Washington	1.05	1.27	11	9	1.12	NA	10	NA
Wyoming	0.76	0.65	12	13	0.75	NA	13	NA
Nevada	0.73	0.76	13	11	1.02	NA	12	NA
Regional Average	1.60	1.51			1.57			
U.S. Average	2.30	1.77			2.27			

	2000				2002			
State	Urban	Rural	Rank-U	Rank-R	Urban	Rural	Rank-U	Rank-R
Arizona	3.56	1.75	1	4	3.41	1.80	1	3
South Dakota	2.17	2.45	2	1	1.99	2.19	3	2
Oregon	2.03	1.84	3	3	2.12	1.69	2	6
Colorado	1.89	2.20	4	2	1.70	2.19	5	1
North Dakota	1.83	1.66	5	5	1.77	1.78	4	4
Idaho	1.76	1.32	6	6	1.56	1.72	6	5
Utah	1.42	1.29	7	7	1.40	1.40	8	8
Montana	**1.26**	**1.26**	**8**	**8**	**1.42**	**1.48**	**7**	**7**
California	1.25	1.00	9	11	1.25	1.00	10	11
New Mexico	1.21	0.76	10	12	1.39	0.74	9	12
Washington	1.11	1.25	11	9	0.98	1.34	12	9
Nevada	1.08	1.22	12	10	1.11	1.20	11	10
Wyoming	0.71	0.62	13	13	0.72	0.64	13	13
Regional Average	1.64	1.43			1.60	1.47		
U.S. Average	2.26	1.70			2.14	1.69		

Rankings determined by Montana Legislative Services Division. NA means not available.
Source: 50-State Property Tax Comparison Study, Payable Years 1995, 1998, 2000, 2002, Minnesota Taxpayers Association.

For example, in Montana for 2002, the effective tax rates for both industrial and commercial property in Choteau are higher than they are in Billings, even though the mill levy in Billings is 560.33 mills and the mill levy in Choteau is 532.98 mills. The lower mill levy is more than offset by a higher sales ratio in Choteau.

Relative Importance of Class Eight Property by County

Attached to this memorandum is a spreadsheet compiled by the Montana Department of Revenue that shows class eight property as a percentage of total taxable value by county. In tax year 2003, business equipment accounted for 6.8% of total statewide taxable value. The percentage amount ranges from a low of 2.5% in Sanders County to a high of 22.4% in Sweet Grass County. The percentage of taxable value attributable to business equipment is lower than the statewide average in 33 counties and is higher in 22 counties. Business equipment accounts for 10% or more of total taxable value in 12 counties.

Effect of Exempting Business Equipment on Class Twelve Railroad and Airline Property

Federal law[8] prohibits states from imposing discriminatory taxes on railroad and airline property. The tax rate on class twelve property is the lesser of 12% or the weighted average tax rate applied to other commercial and industrial property (class four commercial and industrial property, class seven property of certain rural electric cooperatives, class eight business equipment, class nine centrally assessed property, and class thirteen telecommunications and electrical generation property).[9] If the class eight trigger were met, the taxable percentage applied to railroad and airline property would decline until class eight property was exempt and then increase. Table 4 shows (for illustrative purposes only) the revenue impact on class twelve property in tax year 2003 at various tax rates for class eight property.

Table 4: Estimated Revenue Impact on Class 12 Property at Various Tax Rates for Business Equipment, Tax Year 2003

Class Eight Tax Rate	Class 12 Market Value	Calculated Class 12 Tax Rate	Average Class 12 Mill Levy	Revenue	Change in Revenue
3%	$1,176,037,585	3.88%	481.84	$21,986,549	--
2%	1,176,037,585	3.64%	481.84	20, 626,494	($1,360,054)
1%	1,176,037,585	3.38%	481.84	19,153,173	($2,833,375)
0%	1,176,037,585	4.19%	481.84	23,743,135	$1,756,586

Note that if the tax rate on class eight property reaches zero, the tax rate on railroad and airline property would increase because class nine centrally assessed property and class thirteen property would become relatively more important in determining the class twelve tax rate. Under current law, the earliest the trigger could be "pulled" is tax year 2006 (determined in October 2004). Estimating the revenue impact in tax year 2006 and subsequent years would require estimating the taxable value of the relevant other types of property in those years and making certain other assumptions. That task could be done after the Revenue and Transportation Interim Committee adopts the revenue estimating assumptions in November 2004.

[8]The Railroad Revitalization and Regulatory Reform Act of 1976 and the Tax Equity and Fiscal Responsibility Act of 1982.

[9]The definition of "commercial property" in 15-1-101, MCA, specifically excludes agricultural lands, forest lands, and all property described in 15-6-135, MCA.

Combining Class Eight With Class Four

At the February 13, 2004, meeting, Senator Vicki Cocchiarella proposed that business equipment be taxed at the same rate as class four property, either by incorporating class eight with class four or by revising the tax rate applied to class eight. Many states tax all property at a uniform percentage of assessed value or apply differential percentages to residential property and commercial or industrial property (see Table 1 for examples); commercial and industrial personal property in these states is not subject to separate tax rates. Montana is one of a handful of states that applies a separate property tax rate to personal property. The other states include Kansas (taxes inventories and fixtures at a higher rate than other types of property), Missouri (taxes personal property at a slightly higher rate than commercial and industrial property), Ohio (taxes personal property (25%) and inventories (24%) at a lower rate than real property (35%)), and South Carolina (taxes personal property (10.5%) at a higher rate than commercial property (6%), but at the same rate as industrial property).[10] Iowa recently phased out the taxation of personal property.

Prior to 1977, residential, commercial, and industrial land and improvements and certain personal property in Montana were included in the same class. Section 84-301, RCM, provided, in part:

> Class Four. (a) All land, town and city lots, with improvements . . . manufacturing and mining machinery, fixtures and supplies, except as otherwise provided by the constitution of Montana, and except as such property may be included in Class Five, Class Seven or Class Eight.

In 1977, the Montana Legislature significantly revised the property tax structure. The revision was based on an interim study of property assessment and classification.[11] The study was conducted to determine "whether or not the existing classifications are equitable". The revised structure included the creation of a separate class for land and improvements and several different classes of personal property.

In 2003, the Montana Legislature made changes to the taxation of class four property similar to those enacted in 1999 in Senate Bill No. 184 (see p. 5) in response to reappraisal. In particular, the legislation provided different phased-in exemption amounts for residential property and for commercial and industrial property as well as phased-in reductions in the taxable percentages over a 6-year period.[12] The effect of the exemption amounts is to reduce the "effective" taxable percentage applied to the assessed market value of property in class four. If class eight personal property were to be combined with class four property, similar provisions for personal property may have to be adopted to ensure that commercial and industrial real property and business equipment are subject to the same "effective" taxable percentage. Keeping class eight separate,

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[10] 50-State Property Tax Comparison Study, Payable Year 2002, Appendix B.

[11] Teresa Olcott Cohea, Montana's Property Taxes: Assessment and Classification, Subcommittee on Taxation (Helena: Montana Legislative Council, December 1976).

[12] The class four taxable percentages are: 3.40% in tax year 2003, 3.3 % in tax year 2004, 3.33% in tax year 2005, 3.14% in tax year 2006, 3.07% in tax year 2007, and 3.01% in tax year 2008.

as it is now, would require a floating statutory taxable percentage to correspond with the taxable percentages of class four.

Options for the Trigger

Leave trigger in place

Rolling average of wages and salaries--Use a 3-year rolling average for the increase in wages and salaries. The rolling average would be a better indicator of sustained economic growth than a 1-year increase that may be influenced by an unusual event (e.g., bonus payment to aluminum workers in Columbia Falls).

Increase in general fund revenue--In an amendatory message to the Legislature on Senate Bill No. 200, Governor Marc Racicot proposed phasing out the taxation of class eight property "[i]f the state general fund revenue for the fiscal year ending June 30, 2001, exceeds the total general fund revenue for the prior fiscal year by more than 4%".[13] Again, the trigger could go into effect based on unusual circumstances unrelated to economic development, such as a large increase in natural resource taxes caused by higher commodity prices.

Increase in gross state product--Gross state product measures value added and is equal to gross output (sales or receipts and other operating income, commodity taxes, and inventory change) minus its intermediate inputs (consumption of goods and services purchased from other U.S. industries or imported). Gross state product estimates are prepared for 63 industries, including government. Between 1995 and 2001, inflation-adjusted gross state product grew in Montana from $17.9 billion to $20.7 billion, or by 2.5% a year. The table below shows annual percentage changes in gross state product for the United States, the Rocky Mountain region, and Montana.

Table: Annual Percent Change in Gross State Product, 1996-2001

	1996	1997	1998	1999/r	2000/r	2001/p
United States	3.8%	4.9%	5.1%	4.5%	4.7%	4.0%
Rocky Mountain	5.1%	6.3%	5.8%	6.6%	7.3%	0.8%
Montana	1.2%	3.0%	4.3%	2.4%	2.8%	1.2%

Note: r is revised and p is preliminary.
Source: U.S. Bureau of Economic Analysis, May 22, 2003.

Although gross state product is a good measure of overall economic performance, data is not as timely as other information and is subject to revision.

Eliminate trigger

[13]Letter from Governor Marc Racicot to Senator Bruce Crippen, President of the Senate, and Representative John Mercer, Speaker of the House, March 25, 1999.

Concluding Comments

The interstate comparisons of effective property tax rates provide a useful measure of the initial tax burden on hypothetical values of commercial and industrial property. The results of the Minnesota Taxpayers Association studies indicate that the taxation of commercial and industrial property in Montana is more in line with regional averages than in the past. Changes in the assumptions about the composition of property, however, may give different results. But as the Minnesota studies point out:

> This study is most useful when used in connection with other information about state and local tax structures. Some states have relatively high property tax levies because their local governments are more "own-source" revenue dependent. Other states have higher income and sales taxes in part to finance a greater share of the cost of local government. Likewise, the property tax on a selected class of property may be relatively high or low due to policies designed to redistribute the property tax burdens across the classes of property through exemptions, differential assessment rates, or other classification schemes.[14]

At its March 25 and 26 meeting, the Montana Tax Reform Committee discussed the benefit of comparing the overall tax structures of states to gain a better understanding of the initial tax burden of different taxpayers.[15] The Utah State Tax Commission recently released a study that compared state and local taxes paid by businesses as a percentage of gross state product in seven western states. The study did not include Montana, New Mexico, or Wyoming.[16]

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[14] 50-State Property Tax Comparison Study, Payable Year 2002, *op. cit.*, p. vii.

[15] Reported in the Montana Taxpayer, Montana Taxpayer Association, Vol. 38, No. 2 (Helena, March 2004), p. 4.

[16] Douglas Macdonald, Utah State Tax Commission, Revised Western States' Tax Burdens, Fiscal Year 2002-2003, Research Publication 2003-31 (Salt Lake City, 2004).