# Don't Mess With Taxes

## HJR 44 Study of the Taxation of Certain Oil and Natural Gas Property and Other Topics Considered by the Revenue and Transportation Interim Committee


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# 2005-06

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# Table of Contents

**Introduction** . . . . . . . . . . i

**Recommendations** . . . . . . . . . . iii

**Part One: House Joint Resolution No. 44 Study of the Taxation of Certain Oil and Natural Gas Property**

Chapter One: House Joint Resolution No. 44 . . . . . . . . . . 1
Chapter Two: Assessment of Property for Property Tax Purposes . . . . . . . . 3
Chapter Three: Profiles of Oil and Natural Gas Production Companies . . . 10
Chapter Four: A Brief History of the Regulation of Natural Gas . . . . . . . . . . 15
Chapter Five: The Valuation of Oil and Gas Property in Selected States . . 21
Chapter Six: Options for Revising the Assessment and Taxation of Oil and Natural Gas Production Property . . . . . . . . . . 35
Chapter Seven: Property Tax Implications of Industry Proposal . . . . . . . . . 40
Chapter Eight: Conclusion . . . . . . . . . . 49

**Part Two: Overview of Business Income Taxation**

Chapter Nine: Overview of Corporation Income Taxes . . . . . . . . . . 51
Chapter Ten: Perspectives on Business Income Taxation . . . . . . . . . . 63

**Part Three: Other Topics Before the Revenue and Transportation Committee**

Chapter Eleven: Other Topics Before the Revenue and Transportation Committee . . . . . . . . . . 65

## Appendices

Appendix A: Memo on the Central Assessment and Classification of Property . . . 77
Appendix B: Memo from Lee Heiman about Two District Court Rulings . . . . . . . . . 81
Appendix C: LC8000 . . . . . . . . . . 85

## Tables

Ominex Canada, Ltd. Properties . . . . . . . . . . 10
Production (in Thousands of Cubic Feet, MCF) of Selected Natural Gas Producers in Montana, 2000-2004 . . . . . . . . . . 12
Natural Gas Producing States and Method of Valuation of Utility Property . . . . . . 22

County Tax Tables - EnCana Energy Resources, Inc.
Carbon County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 41
Golden Valley County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 41
Stillwater County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 42
County Tax Tables - Fidelity Exploration and Production Co.
Big Horn County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 43
Fallon County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 43
Phillips County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 44
County Tax Tables - Ominex Canada, Ltd.
Blaine County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 45
Glacier County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 45
Liberty County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 46
Phillips County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 46
Toole County . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 47
Summary of the Effects of Reducing the Tax Rate on Natural Gas Production
Property . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 47

# Introduction

This document is the final report on the activities of the Revenue and Transportation Interim Committee during the 2005-06 legislative interim. It is divided into three unrelated parts.

Part One (Chapter One through Chapter Eight) is the final report from the study requested by House Joint Resolution No. 44 on the taxation of certain oil and natural gas property. The report presents the information, analysis, and discussion that the Committee considered during the course of the study. Because many of the issues considered during the course of the study are wending their way through the legal system, the Committee decided not to make any recommendations.

Part Two (Chapter Nine and Chapter Ten) provides some background information on the corporation license tax and on business income taxes. The topic on the taxation of business income arose from a staff recommendation in the Revenue and Transportation Committee's work plan to analyze at least one major tax source each interim. During the 2005 legislative session, several bills were introduced that dealt with some aspect of the corporation license tax. The Committee followed through on the apparent interest in that tax source by reviewing business taxes. Chapter Nine discusses some of the concepts, principles, and practices related to corporation income taxes. It provides a brief overview of: the imposition of state corporation income taxes, the rationale for taxing corporations, the history of the tax in Montana, and some interstate tax comparisons. Chapter Ten summarizes a few perspectives on pass-through entities, domestic corporations, multistate corporations, and problem areas of business taxation that were presented to the Committee at its February 16, 2006, meeting by two tax practitioners and the Department of Revenue.

Part Three summarizes other topics considered by the Committee during the interim. Chapter 11 discusses revenue monitoring, revenue estimating, and access to tax information from the Department of Revenue; rule review related to 1031 exchanges and to the taxation of "little cigars"; and several transportation-related topics, including federal reauthorization of transportation funding, the potential for economic development along the Hi-Line from expanding U.S. Highway 2 to four lanes, highway safety, and state-tribal gasoline tax agreements.

The Committee's final report was prepared before the Committee met on November 15, 2006, to adopt its revenue estimates for introduction during the 60th Legislature. At the November 15 meeting, the Committee also voted to recommend LC0043 to provide for access to all tax information by the Legislative Fiscal Division and the Office of Budget and Program Planning for developing revenue estimates and for other analytical purposes (see Recommendations below).

# Recommendations

During the interim, staff proposed that the Revenue and Transportation Committee request legislation to clarify the distribution of certain fee revenue and to allow the Committee to adopt revenue estimates during a special session. The committee recommends that the 60th Legislature enact the following legislation:

**House Bill No. 21**
An act allowing the Revenue and Transportation Interim Committee to prepare for introduction during a special session of the legislature an estimate of the amount of projected revenue.

**House Bill No. 22**
An act eliminating a provision for making reimbursements to local governments for the fee in lieu of tax on certain vehicles [heavy trucks] that are made under another section of law.

**House Bill No. 23**
An act correcting the erroneous deposit to a state special revenue fund of a percentage of certain driver's license fees.

The Committee also recommends that the 60th Legislature adopt the following House Joint Resolution and enact the following legislation on access to tax information:

**House Joint Resolution No. 2**
A Joint Resolution of the Senate and House of Representatives of the State of Montana establishing an official estimate of the state's anticipated general fund revenue for fiscal year 2007 and each fiscal year of the 2008-2009 biennium for the purpose of achieving a balanced budget as required by Article VIII, section 9, of the Montana Constitution; accepting a preliminary June 30, 2006, unreserved general fund balance that was established based on generally accepted accounting principles; establishing official estimates of certain nongeneral fund revenue; and requesting that the governor's office of budget and program planning use the revenue estimates contained in this resolution as official revenue estimates for fiscal years 2007, 2008, and 2009.

**LC0043**

An act amending the laws governing access to tax information; providing for access to all tax information by the Legislative Fiscal Division and the Office of Budget and Program Planning; requiring confidentiality of federal return information; requiring that confidential information disclosed to the Legislative Fiscal Division and the Office of Budget and Program Planning be subject to restrictions on disclosure; clarifying the authorized disclosure of certain corporation tax information; clarifying penalties for unauthorized disclosure.

Information about these recommendations can be found on the Legislative Branch website at http://laws.leg.mt.gov/pls/laws07/LAW0200W$.Startup.

# Part One

## House Joint Resolution No. 44 Study of the Taxation of Certain Oil and Natural Gas Property

# Chapter One
# House Joint Resolution No. 44

During the 2005 legislative session, Rep. Walter McNutt introduced House Bill No. 569 to clarify the taxation of oil and natural gas flow lines and gathering lines. These types of pipelines transport oil or gas from a production area to a transmission line. The legislation would have taxed all oil and natural gas flow lines and gathering lines, regardless of ownership, as class eight personal property under 15-6-138, MCA, and would have eliminated the central assessment of this type of property. The purpose of the legislation was to deal with property tax disputes between certain taxpayers and the Montana Department of Revenue on the assessment, classification, and taxation of certain oil and natural gas production property. The bill passed the House of Representatives but was tabled in the Senate Taxation Committee.

To deal with the issues raised by House Bill No. 569, Rep. Alan Olson introduced House Joint Resolution No. 44 (HJR 44). The resolution, passed by the 59th Legislature, requests that an appropriate interim committee study the property taxation of oil and natural gas property. The preamble of the resolution describes the rationale for the study:

- Oil and natural gas production machinery and equipment, gathering lines, and transmission lines make up a significant portion of the property tax base of many taxing units across the state.
- Oil and natural gas property that is located in more than one county [or that crosses state lines] is centrally assessed and is taxed at a higher rate than other property.
- Ownership patterns of oil and natural gas property have changed over the last several years.
- Many different entities own oil and natural gas property that is centrally assessed.
- Higher property taxes on this property may impede the competitive position of small producers.
- Several owners of oil and natural gas property have challenged the Department of Revenue's authority to centrally assess certain oil and natural gas property.

- It is in the public interest to establish a balance between the financial needs of local governments and the equitable taxation of oil and natural gas property.

The body of the resolution directs that the study should include but not be limited to:

- an evaluation of the types of oil and natural gas property subject to taxation;
- the ownership patterns of oil and natural gas property subject to central assessment;
- an analysis of the importance of oil and natural gas property to the property tax structure of taxing jurisdictions, including the state;
- a review of the Department of Revenue's assessment procedures and practices with respect to oil and natural gas property, especially property that is centrally assessed by the Department;
- an analysis of the state's policy regarding the taxation of oil and natural gas property.

The HJR 44 study was assigned to the Revenue and Transportation Interim Committee (Committee) by the Montana Legislative Council. On September 30, the Committee tentatively adopted the study plan. During the course of the interim, the HJR 44 study focused primarily on the classification, assessment, and taxation of three natural gas producing entities in Montana—EnCana Energy Resources, Inc., Fidelity Exploration and Production Company, and Omimex Canada, Ltd. EnCana, Fidelity, and Omimex are centrally assessed by the Montana Department of Revenue and are taxed at 12% of market value under 15-6-141, MCA. Each of these companies has protested the assessment, classification, and taxation of its property. The protests have gone through various stages of review, appeals, and settlements.

To a lesser extent, the study also dealt with the taxation of oil production property. This report presents the information, analysis, and discussion that the Committee considered during the course of the study.

# Chapter Two
# Assessment of Property for Property Tax Purposes

## Introduction

This chapter provides a brief overview of the assessment of property for tax purposes in Montana and some significant legislative changes to the taxation of business property. It also highlights the disputes between certain natural gas producers and the Department of Revenue.

Most oil and natural gas production property, including flow lines and gathering lines, are locally assessed and are classified as class eight personal property and taxed at 3% of market value. However, if an entity that is centrally assessed has oil or natural gas production property, that property is also centrally assessed and taxed at 12% of market value.

Article VIII, section 3, of the Montana Constitution requires that the Department of Revenue "appraise, assess, and equalize the valuation of all property which is to be taxed in the manner provided by law". Property is either locally assessed or centrally assessed by the Department of Revenue.

## Locally Assessed Property

Local assessment means that a taxpayer's property is valued separately in each county or taxing jurisdiction in which the property is located. Examples of locally assessed property that is taxed on the basis of market value include:

- Class four property (15-6-134, MCA): residential and commercial land and improvements. The general tax rates for class four property are: 3.22% of market value in tax year 2005, 3.14% in 2006, 3.07% in tax year 2007, and 3.01% after 2007.

- Class five property (15-6-135, MCA): qualifying new industrial property; real and personal property used for the production of gasohol; all property that is devoted to research and development; machinery and equipment used in electrolytic reduction facilities (Columbia Falls aluminum plant). Class five property is taxed at 3% of market value.

- Class seven property (15-6-137, MCA): rural electrical associations that serve less than 95% of the electricity consumers within the incorporated limits of a city or town. Class seven property is taxed at 8% of market value.

- Class eight property (15-6-138, MCA): business equipment, including (noncentrally assessed) oil and gas production equipment. Class eight property is taxed at 3% of market value.

Locally assessed property also includes class three agricultural land (15-6-133, MCA) and class ten forest land (15-6-143, MCA) that are valued on the basis of productivity. The productivity value of class three agricultural land is taxed at the same rate as class four property, and the productivity value of class ten property is taxed at 0.35%.

### Centrally Assessed Property[1]

The Department of Revenue is required to centrally assess the property of a taxpayer that is operated in more than one county or state. Central assessment means that an entity's property statewide is valued as one unit, or by the unitary valuation method. Section 15-23-101, MCA, directs the Department of Revenue to centrally assess each year:

(1) the railroad transportation property of railroads and railroad car companies operating in more than one county in the state or more than one state;

(2) property owned by a corporation or other person operating a single and continuous property operated in more than one county or more than one state, including but not limited to telegraph, telephone, microwave, and electric power or transmission lines; natural gas or oil pipelines; canals, ditches, flumes, or like properties and including, if congress passes legislation that allows the state to tax property owned by an agency created by congress to transmit or distribute electrical energy, property constructed, owned, or operated by a public agency created by congress to transmit or distribute electrical energy produced at privately owned generating facilities, not including rural electric cooperatives;

(3) all property of scheduled airlines;

(4) the net proceeds of mines, except bentonite mines;

(5) the gross proceeds of coal mines; and

(6) property described in subsections (1) and (2) that is subject to the provisions of Title 15, chapter 24, part 12.

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[1] See also Appendix A in this report, memo from Lee Heiman to the Revenue and Transportation Committee on the central assessment and classification of property.

The unitary valuation method uses companywide information regardless of location of the property to determine the market value of the business entity and allocates a proportionate share of the entity's total value to the state and to political subdivisions within the state. There are three indicators to determine the market value of the entity: cost, market, and income. In Montana, the cost indicator is original cost, less depreciation. The income indicator uses the business entity's present value net income stream. Changing market conditions (e.g., risk, price, and market share) will affect valuation under this approach. The market indicators include such factors as sales of comparable assets or the business entity's stock and debt value. Ideally, each of these methods should yield about the same value of the entity being assessed. In practice, however, these methods may produce widely disparate results. To resolve the differences, the appraiser will weight each approach in order to produce a final unit value.[2]

The Department of Revenue is guided by administrative rule 42.22.102 in valuing centrally assessed property:

> 42.22.102 CENTRALLY ASSESSED PROPERTY (1) The department shall centrally assess the interstate and inter-county continuous properties of the following types of companies:
>
> (a) railroad;
>
> (b) railroad car;
>
> (c) microwave;
>
> (d) telecommunications;
>
> (e) telephone cooperatives;
>
> (f) gas;
>
> (g) electric;
>
> (h) electric cooperatives;
>
> (i) ditch;
>
> (j) canal;
>
> (k) flume;
>
> (l) natural gas pipeline;
>
> (m) oil pipeline; and

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[2] Lawrence C. Walters and Gary C. Cornia, "Electric Utility Deregulation and the Property Tax in the United States", in Impacts of Electric Utility Deregulation on Property Taxation, edited by Philip Burling (Lincoln Institute of Land Policy: 2000), p. 49.

> (n) airline.
>
> (2) The property of a centrally assessed company is separated into two categories: operating and non-operating. All operating property will be apportioned to the taxing units as provided in ARM 42.22.121 and 42.22.122.
>
> (3) The department will determine centrally assessed property based on the property's operating characteristics such as but not limited to property use, integration of operations, management, and corporate structure.

In 1999, the Department, through the administrative rule process, added ARM 42.22.102 (3) to clarify its current practice of valuing centrally assessed property under existing law.[3] According to the Department, the rule "effectuates the legislature's intent to centrally assess those unique properties whose true value can only be determined by examining their operating characteristics".[4]

In Montana, centrally assessed property is classified in several different property classes:

- Class five property (15-6-135, MCA): rural electric cooperatives and rural telephone cooperatives and pollution control equipment of centrally assessed property. As noted above, class five property also includes property that is not centrally assessed. Class five property is taxed at 3% of market value.

- Class nine property (15-6-141, MCA): centrally assessed electric power companies; centrally assessed natural gas companies; rural electric cooperative property used for the sole purpose of serving customers representing less than 95% of the electricity consumers in a city or town of more than 3,500 people in which a centrally assessed electric power company also owns property; and other centrally assessed companies. Class nine property is taxed at 12% of market value.
- Class twelve property (15-6-145, MCA): railroad and airline property. Class twelve property is taxed at the average taxable percentage of other commercial and industrial property. A change in the tax rate applied to any

[3] See Department of Revenue's Response No. 8, Montana Administrative Register, 1999 Issue No. 24, p. 2918, December 16, 1999.

[4] DOR's Brief in Support of Cross-Motion for Partial Summary Judgment, in PanCanadian Energy Resources, Inc. v. Montana Department of Revenue, Cause No. DV-02-3223, February 28, 2003.

class of business property will affect the tax rate applied to railroad and airline property.

- Class thirteen property (15-6-156, MCA): electrical generation facilities of a centrally assessed electric power company; electrical generation facilities owned or operated by an exempt wholesale generator or an entity certified as an exempt wholesale generator (e.g., PPL Montana); noncentrally assessed electrical generation facilities (except qualifying facilities, which are taxed as class four property and class eight property); and centrally assessed telecommunications services companies. Class thirteen property is taxed at 6% of market value.

### Trends in Property Classification and Taxation

In 1987, the tax rate on most business personal property was between 11% and 16% of market value and class four land and improvements were taxed at 3.86% of market value. Most centrally assessed property (except for railroad and airline property, rural cooperatives, and mines) was taxed at 12% of market value. In 1989, the Legislature consolidated the taxation of most business personal property and reduced the tax rate to 9%. Since then the Legislature has gradually reduced the tax rate on business personal property. In 1999, the Legislature reduced the tax rate on business personal property to 3% and phased out over a 4-year period the taxation of class six property, which included livestock, certain rental personal property, canola facilities, and malting barley facilities. Before the consolidation and reduction of taxation on business personal property, the disparity between the tax rates of regulated utilities and other business was related to the lower tax rate on commercial land and improvements. Typically taxes paid by regulated utilities are included in the rate base.

Centrally assessed class nine property has included regulated electrical and natural gas utilities, telephone companies, oil and gas transmission lines, railroads, and airlines. Changes in federal law and the restructuring of electric and telecommunications services markets have led to the reclassification of certain property previously included in this class. For example, the federal Railroad Revitalization and Regulatory Reform Act of 1976 and the Tax Equity and Fiscal Responsibility Act of 1982 prohibit states from imposing discriminatory taxes on the railroad and airline industries, respectively. The property tax rate on railroad and airline property may not be higher than the tax rate generally applicable to

commercial and industrial property. In 1985, the Montana Legislature reclassified railroad and airline property. In 1999, the Montana Legislature reclassified electrical generation facilities and telecommunications property to help make these industries more competitive with other states. The Legislature also imposed a wholesale energy transaction tax and a retail telecommunications excise tax to help offset the revenue loss from the lower property tax rates on these properties.

### The Property Tax Dispute

Two taxpayers[5] have disputed the Department of Revenue's central assessment of natural gas gathering lines and related property located in various counties. In tax year 2004, Omimex Canada, Ltd., reported its personal property for local assessment to the various counties.[6] The Department determined that the property should be centrally assessed and taxed at 12% rather than at the class eight personal property tax rate of 3%. In April 2004, Omimex filed a complaint for declaratory judgment in the District Court in Helena, asking the court to find, among other things, that its personal property be locally assessed and that ARM 42.22.102(3) is invalid.[7] The complaint contends that the subject property consists of unregulated gathering lines and related property that transmits natural gas from various wellhead connections to various interconnections with transmission lines in which Omimex has no ownership interest. The complaint states that similarly situated taxpayers with comparable property operating in more than one county are locally assessed and are taxed at 3% of market value.[8] A trial in District Court on the complaint, originally scheduled to begin on December 12, 2005, was rescheduled to September 18, 2006.

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[5]EnCana Energy Resources has also disputed the central assessment of its property, but this company was not a significant part of the HJR 44 study.

[6]The Montana Power Company sold its natural gas exploration, production, and marketing assets to PanCanadian Petroleum. In 2003, Omimex purchased certain gathering facilities in Montana from EnCana Oil and Gas, a successor company to PanCanadian Petroleum.

[7]Omimex Canada, Ltd. v. State of Montana, Department of Revenue, Montana First Judicial District, Cause No. DV-2004-2288, April 14, 2004.

[8]On August 9, 2005, in a partial summary judgment, District Court Judge Jeffrey M. Sherlock ruled in Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County) that ARM 42.22.102(3) was invalid. Conversely, on October 27, 2003, District Court Judge Marc G. Buyske ruled in partial summary judgment in PanCanadian Energy Resources v. Department of Revenue (No. DV-02-3223, Twelfth Judicial District, Liberty County) that ARM 42.22.102(3) is a valid rule. For more information about the two district court rulings, see Appendix B in this report, memo from Lee Heiman, Committee staff attorney, to the Revenue and Transportation Committee.

Montana-Dakota Utilities has appealed the valuation of its property as well as the classification of "indirect subsidiaries" as centrally assessed property to the State Tax Appeal Board. The appeal claims that the Department of Revenue improperly included in the appraisal of the Williston Basin Interstate Pipeline Company the value of gathering lines owned by Bitter Creek Pipelines, LLC, and gas production property owned by Fidelity Exploration and Production Company. The appeal further states that by including the gathering lines of Bitter Creek and the production property of Fidelity in the Williston Basin assessment subjected property of Fidelity to the class nine 12% tax rate rather than the class eight 3% tax rate.[9][10] Williston Basin and the Department of Revenue have settled the property tax disputes for property tax years 2002 through 2006.

[9]Montana-Dakota Utilities Co., Williston Basin Interstate Pipeline Co., and Fidelity Exploration and Production Co. v. Department of Revenue of the State Of Montana, Before the State Tax Appeal Board of the State of Montana, No. SPT-2004-2, June 24, 2004.

[10]The appeal also contends that the Department of Revenue used capitalization rates in its appraisal that are unreasonably low, improperly included contributions in aid of construction, and failed to account for plant decommissioning costs.

# Chapter Three
# Profiles of Oil and Natural Gas Production Companies

## Introduction

At the time of the this report, EnCana, Fidelity, and Omimex are the only natural gas production companies that are centrally assessed. This chapter provides a brief overview of EnCana Energy Resources, Omimex Canada, Ltd., and MDU Resources Group companies including Fidelity Exploration and Production Company, Bitter Creek Pipelines, LLC, and Williston Basin Interstate Pipeline Company. It also includes an overview of Encore Operating Company. Although primarily an oil production company in Montana, Encore also produces a small amount of natural gas in the state, and, as noted below, could be subject to central assessment.

## Ominex Canada, Ltd.

Omimex is an independent oil and natural gas production company. Its corporate headquarters are located in Fort Worth, Texas, and has Montana offices in Butte and Cut Bank. Omimex acquired most of its Montana property from EnCana in 2003.[1] Omimex owns property in Blaine, Glacier, Hill, Liberty, Phillips, Toole, and Valley Counties. Omimex's properties generally consist of:

| **Cut Bank Area Glacier and Toole Counties** | **Reagan Glacier and Toole Counties** | **Battle Creek Blaine and Phillips Counties** | **Shelby Area Liberty and Toole Counties** | **Bowdoin Phillips and Valley Counties** |
|---|---|---|---|---|
| Cut Bank gathering<br>Cut Bank gas plant<br>Cut Bank pipeline<br>Big Rock gathering | Reagan field gathering | Battle Creek gathering<br>Chinook pipeline | Kevin Sunburst gathering, Toole County<br>East Keith gathering<br>Utopia gathering<br>East Keith pipeline | Bowdoin field gathering<br>Whitewater pipeline |

Source: Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County), January 17, 2006.

[1] In 2002, PanCanadian Energy Resources merged with Alberta Energy Company to form EnCana. PanCanadian Energy had previously acquired the Montana Power Company's exploration, production, midstream, and marketing property, including the gathering and processing facilities held by North American Resources Company, a Montana Power Company wholly owned subsidiary.

Revenue and Transportation

In an order on motions for summary judgment, District Court Judge Jeffrey M. Sherlock provided some detail on the location and nature of Omimex's property in Montana.[2] He described the properties as consisting of hundreds of miles of natural gas pipelines and about 1,400 wells. The Cut Bank pipeline crosses the county line between Glacier and Toole Counties, and another natural gas pipeline crosses the border between Montana and Alberta, Canada. The East Keith Pipeline runs from Hill County through Liberty County into Toole County.

Omimex transports in its pipelines its own natural gas, third-party gas, and gas of which it owns a working interest. For example, the Whitewater pipeline transports third-party gas to the U.S.-Canadian border crossing. The Chinook pipeline also delivers gas to the border crossing. The court noted that it appears that none of the properties are physically connected with each other.

Omimex has a single gas marketing agreement with Wisconsin Public Services. One hundred percent of the gas owned by Omimex and transported to market on its pipelines is sold off the TransCanadian pipeline, the Northern Border pipeline, and NorthWestern Energy pipelines.

### Fidelity Exploration and Production Company, Bitter Creek Pipelines, and Williston Basin Interstate Pipeline

Fidelity Exploration and Production Company is a direct wholly owned subsidiary of WBI Holdings, Inc; it is a MDU Resources Group, Inc., company. In the Rocky Mountain region, Fidelity operates primarily in Colorado, Montana, North Dakota, and Wyoming. Fidelity operates oil and natural gas leases in the Baker area (Cedar Creek Anticline) in southeastern Montana (Fallon County) and southwestern North Dakota, the Bowdoin area located in northcentral Montana (Phillips and Valley Counties), and the Powder River Basin of Montana (Big Horn County) and Wyoming (coal bed methane). It also operates in Alabama, Arkansas, Louisiana, New Mexico, Oklahoma, Texas, and the Gulf of Mexico.[3] Several years ago, Fidelity acquired Redstone Gas Partners production company, including coal bed methane property.

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[2] Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County), January 17, 2006.

[3] U.S. Securities and Exchange Commission, Form 10-K, MDU Resources Group, Inc. For the fiscal year ended December, 31, 2005. Available from http://www.sec.gov/Archives/edgar/data/67716/000006771606000058/mdu200510k.htm.

Bitter Creek owns gathering lines in gas fields located in Montana, Wyoming, Colorado, and Kansas. It is an unregulated company and transports gas, including gas produced by Fidelity, from the wellhead to a central location in the gas field for treatment and injection into a natural gas transmission pipeline. Its pipelines are interconnected with the Williston Basin Interstate Pipeline as well as with other pipelines.

Williston Basin Interstate Pipeline, regulated by the Federal Energy Regulatory Commission, transports and stores natural gas in the four states in which Montana-Dakota Utilities operates (Montana, North Dakota, South Dakota, and Wyoming).[4]

## EnCana Energy Resources

EnCana Energy Resources operates in Carbon, Golden Valley, and Stillwater Counties. Its property is centrally assessed by the Department of Revenue. EnCana also operates in the Rocky Mountain region and in the Gulf of Mexico.

## Natural Gas Production Data

The table below shows recent natural gas production history of several production companies operating in Montana. Consolidations, acquisitions, and mergers have changed the relative importance of certain producers since 2000. For example, EnCana was the fourth largest producer in the state in 2002 and 2003. In 2004, it was the ninth largest producer. Fidelity has been the largest producer of natural gas since 2001.

**Production (in Thousands of Cubic Feet, MCF) of Selected Natural Gas Producers in Montana, 2000-2004**

| Company | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| WBI Production | 12,591,781 | 3,631,400 | Consolidated with Fidelity Oil Group in 1999 | | |
| Ocean Energy Resources | 10,538,520 | 14,814,672 | NA | NA | NA |
| Ocean Energy | 9,125,763 | 2,960,931 | 16,778,669 | 11,063,572 | Merged with Devon in 2003 |
| Devon Louisiana | NA | NA | NA | 6,083,660 | 18,183,453 |

[4]Presentation by John Alke, in Minutes, Revenue and Transportation Interim Committee, December 2, 2005, Exhibit #5. The Minutes and links to the exhibits are available on the Committee's webpage at http://leg.state.mt.us/css/committees/interim/2005_2006/rev_trans/default.asp.

| Production (in Thousands of Cubic Feet, MCF) of Selected Natural Gas Producers in Montana, 2000-2004 | | | | | |
|---|---|---|---|---|---|
| Company | 2000 | 2001 | 2002 | 2003 | 2004 |
| Klabzuba Oil and Gas | 6,192,395 | 9,841,274 | 9,413,276 | 7,815,151 | 6,934,708 |
| Redstone Gas Partners | 3,494,723 | 1,792,636 | Acquired by Fidelity Exploration and Production in 2000 | | |
| Montana Power Gas | 3,066,480 | 3,038,384 | NA | NA | NA |
| EnCana Energy Resources, Inc. | 996,771 | 973,858 | 8,909,103 | 6,700,639 | 554,985 |
| Montana Power | 138,011 | 205,867 | 59,372 | NA | NA |
| Fidelity Exploration & Production | 109,346 | 17,461,270 | 28,703,166 | 30,582,744 | 40,694,269 |
| Omimex Canada | NA | NA | NA | 348,935 | 3,848,751 |
| NorthWestern Energy | NA | NA | 136,410 | 170,680 | 160,312 |

Source: Montana Board of Oil and Gas Conservation, *Annual Report*, various years.

## Encore Operating Company

Encore Operating Company is the largest oil producer in Montana. It produces oil from the Cedar Creek Anticline that stretches almost interrupted from Bowman County in southeastern North Dakota through Fallon, Wibaux, Prairie, and Dawson Counties in Montana. Flow lines transport oil to separation and processing facilities owned by Encore. From the processing facilities, oil is transported on third party lines to the Baker gathering station for transfer to larger transmission lines. It appears from a map included in the presentation to the Committee at its February 17, 2006, meeting that a small portion of Encore's flow lines cross the state border from North Dakota. Likewise, a small portion of the company's flow lines appears to cross the county line between Dawson and Prairie counties to a third-party pipeline.[5]

Encore produces a small amount of natural gas in Montana (based on the Board of Oil and Natural Gas annual reports, the amount is less than 10,000 MCF). An Encore pipeline moves gas from Wibaux County to a compressor station in Fallon County. From there, the gas is transported by a third-party pipeline to a gas plant, also in Fallon County.

[5] Bob Jacobs, "Encore Operating, LP", in Minutes, Revenue and Transportation Committee, February 16 and 17, 2006, Exhibit #33.

The property of oil production companies is locally assessed and taxed at 3% of market value. However, if the property of an oil production company were to cross county lines, that property would be subject to central assessment and taxed at 12% under current law.

# Chapter Four
# A Brief History of the Regulation of Natural Gas[1]

In Montana, as well as other states, the assessment and taxation of certain natural gas property has been linked to regulatory policy. This chapter presents a brief history of the regulation of the supply of natural gas, focusing primarily on federal regulatory policy.

## Municipalities Begin Regulation

The first regulation of natural gas was initiated by municipalities in the mid-1800s. Natural gas was produced from coal for delivery to the municipality. Municipalities determined that a single provider could deliver natural gas more efficiently than several providers. However, because of the monopolistic characteristics of a single provider of natural gas, municipal authorities regulated rates and other aspects of the market in the public interest. As natural gas distribution expanded within a state, the state took over the regulatory responsibilities with the establishment of public utility commissions or public service commissions.

## Federal Government Takes Over

In the early 1900s, as technology improved for transporting natural gas, pipeline companies began the interstate shipment of natural gas. Between 1911 and 1928, some states attempted to assert regulatory oversight of interstate natural gas pipelines. However, the U.S. Supreme Court ruled that state regulation of interstate pipelines violated the Commerce Clause of the U.S. Constitution. It was not until 1938, with the enactment of the Natural Gas Act, that the federal government asserted regulatory control of interstate pipelines. The act gave the Federal Power Commission[2] the authority to regulate rates that interstate pipelines (natural gas companies) could charge for interstate delivery of natural gas and, under amendments adopted in 1942, to certify the construction of new pipelines. The

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[1]The discussion on the regulation of natural gas draws heavily from "The History of Regulation" (NaturalGas.org, 2004, available from http://naturalgas.org/regulation/history.asp; Internet; accessed November 22, 2005).

[2]Congress created the Federal Power Commission in 1920 to coordinate hydroelectric projects under federal control.

purpose of the act was to protect consumers by ensuring "just and reasonable" prices for natural gas and a "fair profit" for natural gas companies.[3]

The Natural Gas Act specifically exempted the production and gathering of natural gas from regulation because the states had the authority to regulate local production and gathering and because, unlike the interstate transportation of natural gas, production and gathering were generally competitive.[4] In a series of cases decided in the 1940s, the U.S. Supreme Court ruled that natural gas producers that were affiliated with purchasing pipelines were subject to federal regulation. Based on those decisions, the Federal Power Commission determined that producers that were not affiliated with a pipeline were not subject to regulation. In particular, the commission conducted an investigation of whether Phillips Petroleum Co. was a natural gas company under the Natural Gas Act. The company was engaged in the production, gathering, processing, and sale of natural gas. It sold its gas to five interstate pipelines. The commission concluded that its jurisdiction did not extend to Phillips Petroleum. However, the U.S. Supreme Court came to the opposite conclusion by ruling that the company "is a 'natural-gas company' within the meaning of the Natural Gas Act, and its sales in interstate commerce of natural gas for resale are subject to the jurisdiction of, and rate regulation by, the Federal Power Commission."[5] The Court determined that the "sales by this Company are not part of the 'production or gathering of natural gas,' which are excluded from the Commission's jurisdiction. . ., since the production and gathering end before the sales occur."[6]

As a result of this decision, the Federal Power Commission gained additional regulatory authority of natural gas markets. Over the years, it adopted a number of pricing schemes for natural gas producers that sold gas to interstate pipelines. These included treating each producer as a public utility and setting prices based on cost of service; setting rates based on geographic area; and establishing national price

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[3]Castaneda, Christopher, Review of *The Natural Gas Market: Sixty Years of Regulation and Deregulation*, by Paul MacAvoy. Economic History Services (http://www.eh.net/bookreviews/library/0385.shtml; Internet, accessed August 8, 2005) pp. 1-4.

[4]Bryce, David V., "Pipeline Gathering in an Unbundled World: How FERC's Response to 'Spin Down' Threatens Competition in the Natural Gas Industry", *Minnesota Law Review*, Vol. 89, No. 2 , obtained from Thomson/West (Minneapolis, MN: Minnesota Law Review Foundation, December, 2004) p. 4.

[5]Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

[6]*Ibid*.

ceilings. Each of these approaches inhibited natural gas production by maintaining artificially low prices. As a result, the interstate demand for natural gas exceeded the supply, which over time led to shortages.

## Federal Government Changes Course

In 1978, Congress enacted the Natural Gas Policy Act to deal with natural gas shortages in interstate markets by providing for the gradual deregulation of wellhead prices of natural gas. More competitive prices and long-term "take-or-pay" contracts with producers led to an oversupply of natural gas.

Deregulation took another step forward in the early 1980s when large customers of natural gas who had the capability of switching their source of energy were allowed to purchase natural gas directly from the producer. These arrangements were ruled discriminatory because other customers (e.g., local distribution companies) were not allowed to purchase natural gas from the producer. However, the Federal Energy Regulatory Commission[7] decided that there would be advantages to allowing customers to purchase directly from producers. In 1985, it issued Order No. 436 to permit interstate pipelines to voluntarily offer transportation services to customers on a "first come, first served basis." FERC established a range of prices that pipelines could charge for transportation services, but otherwise pipelines were allowed to transport gas for others at competitive rates. The new rule (referred to as the Open Access Order) began the process of changing the function of interstate pipelines from providing bundled services (an integrated supply system that was capable of delivering natural gas from the wellhead to the ultimate retail gas consumer[8]) to providing transportation services.

In 1987, FERC issued Order No. 500 to encourage interstate pipelines to buy out take-or-pay contracts. Pipelines were allowed to pass on a portion of those costs to local distribution companies who in turn were allowed to pass on these costs to retail customers.

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[7]The Federal Energy Regulatory Commission replaced the Federal Power Commission under the Department of Energy Organization Act of 1977.

[8]"FERC Policy on Natural Gas Gathering System Ownership Since 1992", Energy Information Administration, U.S. Department of Energy (Energy Information Administration: Washington, D.C., modified on January 7, 2005, available from http://www.eia.doe.gov/oil_gas/natural_gas/analysis_publications/ngmajorleg/fercpolicy.html; Internet; accessed November 11, 2005) p. 1.

The move to deregulate most natural gas prices at the wellhead occurred in 1989 with the enactment of the Natural Gas Wellhead Decontrol Act. Under the act, all federal regulation of prices at the wellhead for the first sale of natural gas were eliminated on January 1, 1993. The term "first sale" means the sale of natural gas:

- to an interstate or intrastate pipeline;
- to a local distribution company;
- to a person for use by the person;
- that precedes the sale to any of the above businesses;
- as determined by the Federal Energy Regulatory Commission.

The first sale of natural gas does not include the sale by an interstate or intrastate pipeline, local distribution company, or any affiliates of these businesses unless produced by the business.[9]

In 1992, FERC issued Order No. 636 to require interstate natural gas pipelines to separate, by November 1, 1993, their transportation and sales services and to transport natural gas for all qualified shippers on a nondiscriminatory basis. The order meant that all pipeline customers "have a choice in selecting their gas sales, transportation, and storage services from any provider, in any quantity."[10] Although pipelines were not permitted to sell any product as a bundled service, they could still provide a variety of services, such as gathering and storage. However, the trend has been to establish separate production and marketing affiliates, many pipeline companies having transferred their unbundled services to another corporate entity.[11] While FERC still has regulatory authority over pipelines and storage, natural gas purchases are essentially free from regulation.[12]

In 1997, the Montana Legislature enacted Senate Bill No. 396 (Ch. 506, L. 1997) to require a natural gas utility that provides customer choice and open access to

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[9]See 15 U.S.C. 3301(21).

[10]NaturalGas.org, *op. cit.*, p. 10.

[11]"Natural Gas 1994: Issues and Trends", Energy Information Administration, U.S. Department of Energy (Energy Information Administration, Office of Oil and Gas: Washington, D.C., July 1994 http://www.eia.doe.gov/pub/oil_gas/natural_gas/analysis_publications/natural_gas_1994_issues_trends/pdf/056094.pdf; Internet, accessed November 11, 2005) p. 39.

[12]*Ibid.*, p. 1.

"functionally separate its natural gas production and gathering from its natural gas transmission, storage, and distribution services and remove natural gas production and gathering from the rate base."

### How are Gathering Systems Treated?

Gathering systems accumulate and transport natural gas from a well to an acceptance point of a transportation pipeline. In the past, FERC used two tests to distinguish jurisdictional transportation of natural gas from nonjurisdictional gathering systems. Under the "behind-the-plant" test, pipelines upstream of compressors and processing plants (toward the wellhead) were considered gathering lines, while pipelines below the plants were considered transportation systems. Under the "central-point-in-the-field" test, lateral lines that collected and transported natural gas that required no processing from separate wells that then converged into a single large line were considered gathering lines, while pipelines downstream of the collection were considered transmission lines. In 1983, FERC adopted a "primary function" test that takes into account several physical and nonphysical factors.[13] The physical factors include:

- the length and diameter of the pipeline (longer and wider pipelines indicate a transportation system);
- the extension of pipeline beyond the central point in the field;
- the pipeline's geographic configuration (a weblike pattern indicates a gathering system);
- the location of compressors and processing plants ("behind-the-plant" test);
- the location of wells along all or a part of the facilities (indicates a gathering system); and
- the operating pressure of the pipeline (higher pressure needed to propel gas indicates a transportation system).[14]

[13]These factors were instituted primarily to deal with production and gathering of natural gas occurring on the Outer Continental Shelf. Apparently, these factors work fairly well for on-shore gathering and production, but several off-shore companies have challenged FERC's determinations.

[14]ExxonMobil Gas Mktg. Co. v. FERC, 297 F.3d 1071, 1076-77 (D.C. Cir. 2002).

The nonphysical factors include:

- the purpose, location, and operation of the pipelines;
- the general business activity of the owner of the pipeline;
- whether a jurisdictional determination (i.e., gathering versus transmission) is consistent with the objectives of the Natural Gas Act and other legislation; and
- the changing technical and geographic nature of exploration and production activities.[15]

Under the primary function test, no one factor is determinative, nor do all factors apply in every situation.[16] Despite these physical and nonphysical factors, it may not always be clear whether a particular portion of pipeline should be treated as gathering lines or transmission lines.

### Last Observation

Changes in federal and state regulatory policy have significantly changed the structure of natural gas markets. The dynamics of natural gas markets have changed significantly over the last few decades beginning with the gradual deregulation of wellhead prices at the federal level in 1978. In 1992, the Federal Energy Regulatory Commission issued Order No. 636 to require natural gas pipeline companies to provide open access for transmission services and to separate its production and gathering operations.

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[15] *Ibid.*

[16] Energy Information Administration, "FERC Policy on Natural Gas Gathering System Ownership Since 1992", *op. cit.*, p. 2.

# Chapter Five
# The Valuation of Oil and Gas Property in Selected States

## Introduction

This chapter summarizes how several states value oil and natural gas pipelines (flow lines, gathering lines, transmission lines, and natural gas distribution lines) for property tax purposes. The states selected for this review have significant gas production, and the state agency responsible for centrally assessing certain types of property uses the unitary valuation method, as does Montana, to determine the market value of that property. The table on the next page lists gas producing states, indicates the method of assessment for public utility property, and highlights the states selected for review. A significant amount of information about state assessment procedures was obtained from "Survey of Railroad and Utility Taxation Practices Among the States: 2005 Update" prepared by the New York Office of Real Property Services (ORPS study).[1] Additional information was obtained from telephone conversations with state property assessment officials.

## Wyoming[2]

The Wyoming Department of Revenue uses the unitary method of valuation[3] for determining the fair market value of the following types of property (39-13-102, WS):

- the gross product of all mines and mining claims;
- pipeline companies;
- electric utilities;
- railroad companies;
- rail car companies;
- telecommunications companies;
- other public utilities.

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[1] The report is available on the Internet at http://www.orps.state.ny.us/ref/pubs/railroadutility/section1.htm.

[2] Kenneth Uhrich, Wyoming Department of Revenue, telephone conversation January 15, 2006.

[3] The Wyoming Department of Revenue defines "unitary valuation" as "the process of determining the value of a company as a whole without reference to individual parts. The unitary approach is used in the valuation of properties which derive their value from interdependent assets working together. The market value is not a summation of fractional appraisals, but the value of a company as an operating unit."

| **Natural Gas Producing States and Method of Valuation of Utility Property** | | | | |
|---|---|---|---|---|
| State* | Number of Gas and Gas Condensate Wells** | Marketed Natural Gas Production in MMCF*** | Unitary Valuation | Property Classification System |
| **Alabama** | 5,157 | 316,943 | Yes | 4 classes |
| Alaska (1)(2) | 195 | 471,213 | No | No |
| Arizona | 9 | 331 | Yes | 9 classes |
| Arkansas | 7,606 | 169,279 | Yes | No |
| **California (3)** | 1,249 | 319,665 | Yes | Real and personal |
| Colorado (4) | 18,774 | 1,037,121 | Yes | 2 classes |
| Illinois | 240 | 126 | No (RR real, yes) | Personal prop. exempt |
| Indiana | 2,291 | 1,464 | Yes | No |
| **Kansas** | 17,387 | 394,173 | Yes | 7 classes of real, 6 classes of pers. |
| Kentucky | 12,900 | 87,609 | Yes | Residential & comm |
| **Louisiana** | 16,939 | 1,382,253 | Yes | 4 classes |
| Maryland | 7 | 22 | Yes | No |
| **Michigan** | 8,600 | 260,820 | Yes | No, 50% of value |
| **Mississippi** | 427 | 145,374 | Yes | 5 classes |
| Montana | 4,539 | 96,199 | Yes | 13 classes |
| Nebraska | 109 | 1,168 | Yes | 4 classes |
| New Mexico | 37,100 | 1,632,536 | Yes | No 33.3% of value |
| New York | 5,878 | 35,044 | No | No |
| North Dakota (5) | 117 | 55,645 | Yes | 2 classes |
| **Ohio (6)** | 33,828 | 120,080 | Yes | Yes |
| Oklahoma | 34,334 | 1,690,818 | Yes | No |
| Oregon | 15 | 467 | Yes | No |
| Pennsylvania | 42,437 | 157,800 | No | No |
| South Dakota (7) | 61 | 1,025 | Yes | Yes |
| Tennessee | 430 | 1,803 | Yes | Yes |
| Texas | 68,572 | 5,189,998 | No | No |
| Utah (8) | 3,220 | 276,969 | Yes | 2 classes |
| Virginia (9) | 3,506 | NA | No | No |
| West Virginia (10) | 46,203 | 187,723 | Yes | 4 classes |
| **Wyoming** | 18,154 | 1,590,746 | Yes | 3 |

Notes:
*States marked in bold are included in report
**Wells for calendar year 2004
***Production from different years
(1) Property used for oil or gas exploration, production, or pipeline transportation is exempt from local assessment but subject to state tax of 20 mills.
(2) The only property that is centrally assessed and apportioned is the Trans-Alaska Pipeline System.
(3) Classification system between real and personal property for utility property under unit valuation method.
(4) Residential property is taxed at 9.15% (annually adjusted) and all other property taxed at 29%.
(5) Personal property is exempt from taxation in North Dakota; however utility property is subject to taxation as personal property. Residential property is taxed at 9%; all other property is taxed at 10%.
(6) In 2005 property was assessed at 25% to 88% of true value; all real property is assessed at 35%. The personal property tax will be phased out by 2009. Assessment rates for certain other property is reduced.
(7) Real property is assessed at 85% of true value (personal property is exempt). There are three separate property tax rates: agricultural, owner-occupied housing, commercial and all other property.
(8) Primary residential property is assessed at 25% of market value; all other property is assessed at 100% of market value.
(9) Unitary valuation has been banned by state courts.
(10) Property is assessed at 60% of market value. Four classes of property are taxed at the following rates: intangible property ($0.50/$100 of value), owner-occupied residential property ($1.00/$100 of value), other real and personal property located outside a municipality ($2.00/$100 of value), and other real and personal property located within a municipality ($2.50/ $100 of value).

Sources: Energy Information Administration for wells and production and New York Office of Real Property Services, "Survey of Railroad and Utility Taxation Practices Among the States: 2005 Update" for property tax information.

The department uses income, market, and cost approaches to value this type of property. The lack of good information (e.g., negative income or privately held entity) may preclude the application of one or more of the approaches (ORPS study).

According to a Wyoming Department of Revenue memorandum,[4] there are two types of pipelines: (1) gathering systems; and (2) common carrier pipelines. Gathering systems carry natural gas to processing centers to be treated to meet quality standards for introduction into a transmission pipeline. After treatment, the gas passes through a metering device, which marks the point of sale by the producer. Transmission pipelines (or common carrier pipelines) are subject to regulation by FERC or the Wyoming Public Service Commission. Regulatory changes at the federal and state level during the late 1980s and early 1990s created the distinction between nonregulated gathering lines and transmission system. In particular, after FERC issued Order No. 636 in 1992, production, gathering, and processing services were "spun-off" from regulated pipeline companies into nonregulated companies.[5]

For Wyoming severance tax purposes, the term "gathering lines" means the transportation of crude oil, lease condensate, or natural gas from multiple wells by separate and individual pipelines to a central point of accumulation, dehydration, compression, separation, heating, and treating or storage (39-14-201, WS). For property tax purposes, gathering lines, even if they cross county lines, are typically locally assessed and transmission pipelines are assessed by the state. In determining whether a particular pipeline is part of a gathering system or a transmission system, the Wyoming Department of Revenue reviews the business activity of the company that owns the pipeline and the regulatory environment in which the company operates.[6]

The Wyoming Department of Revenue considers two factors to distinguish between gathering systems subject to local assessment and transmission lines subject to state assessment. First, if the producer owns the gas (or oil) in the pipeline, the

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[4] Chubb, Ronald J., "Pipeline Assessment Clarification", Memorandum (00-030), Wyoming Department of Revenue, March 25, 2002.

[5] *Ibid.*

[6] *Ibid.*

pipeline is part of the gathering system. Second, if the pipeline is downstream from the meter, the pipeline is part of the transmission system.[7]

Wyoming has three categories of taxable property (39-13-103, WS):

- mineral property is taxed at 100% of market value;
- industrial property (including oil and gas property and the property of public utilities) is taxed at 11.5% of market value; and
- all other real and personal property (commercial and residential) is taxed at 9.5% of market value.

### Kansas[8]

The Kansas Department of Revenue uses the unitary valuation method to assess the property of public utilities. All other property is locally assessed. The Department uses the income, market, and cost methods to value public utility property. The weighting of each approach depends on the availability and reliability of information. Generally, the Department considers the capitalized income approach to be the most reliable (ORPS study).

Kansas defines public utility property (79-5a01, KSA) as an entity that owns, controls, and holds for resale stored natural gas in an underground formation in the state or that operates a business of:

- a railroad;
- transmitting telegraphic messages;
- transmitting telephonic messages;
- transporting or distributing to, from, through or in the state natural gas, oil or other commodities in pipes or pipelines, or engaging primarily in the business of storing natural gas in an underground formation;
- generating or distributing electric power;
- transmitting water if for profit or subject to regulation of the state corporation commission; and
- transporting cargo or passengers by means of any vessel used in navigating any of the navigable watercourses within or bordering upon the state.

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[7] *Ibid.*

[8] Roger Dallam, Property Assessment Division, Kansas Department of Revenue, telephone conversation, January 15, 2006.

The definition of a public utility specifically excludes intracounty oil or natural gas gathering systems; this type of property is considered commercial and industrial property. Wells and flow lines are not considered part of the centrally assessed unit.[9] Intracounty gathering systems are depreciated on a 7-year, straight-line basis to a minimum of 20% of original cost and are taxed at 25% of the depreciated value.[10]

Kansas has seven classes of real property and six classes of personal property, and property is assessed at various percentages (79-1439, KSA). Real property is assessed at the following percentages of market value:

- real property used for residential purposes, 11.5%;
- land devoted to agricultural use (valued on productivity), 30%;
- vacant lots, 12%;
- real property which is owned and operated by a not-for-profit organization not subject to federal income taxation, 12%;
- public utility real property, 33% (except railroad property, which is taxed at the average rate of all other commercial and industrial property);
- real property used for commercial and industrial purposes and buildings and other improvements located upon land devoted to agricultural use, 25%; and
- all other urban and rural real property, 30%.

Personal property is assessed at the following percentages of market value:

- mobile homes used for residential purposes, 11.5%;
- mineral leasehold interests, 30%, except oil leasehold interests, the average daily production from which is five barrels or less, and natural gas leasehold interests, the average daily production from which is 100 mcf or less, which are assessed at 25%;
- public utility tangible personal property, 33% (except railroad personal property which is assessed at the average rate of all other commercial and industrial property);
- motor vehicles, 30%;
- commercial and industrial machinery and equipment, 25%; and
- all other tangible personal property not otherwise specifically classified, 30%.

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[9] *Ibid.*

[10] In re CIG Field Services Co., 279 Kan. 857, 112 P.3d 138, 149 (2005).

CIG Field Services Company appealed the Kansas Department of Revenue's valuation and assessment of its gathering lines as public utility property to the Kansas Board of Tax Appeals for tax years 1997 to 2003. The company contended that the different tax treatment of interstate and intercounty gathering systems from intracounty systems violated the federal Interstate Commerce Clause and federal and state Equal Protection Clauses. The majority of the Board of Tax Appeals found that CIG and intracounty natural gas systems were competitive and thus similarly situated. However, the Board does not have the authority to rule on constitutional issues and therefore upheld the Department of Revenue's valuation and assessment for the years in dispute.[11]

CIG appealed the Board's decision to the Kansas Supreme Court. The Court ruled that the statute violated the federal Interstate Commerce Clause because it "discriminates against and has the effect of unduly burdening interstate commerce by defining interstate and intercounty natural gas gathering systems as public utilities taxable at a higher assessed value and higher rate than intracounty systems . . .".[12]

**Mississippi**[13]

The Mississippi State Tax Commission uses the unitary valuation method to assess the value of the operating property of railroads, oil or gas pipeline companies, electric companies, and other public service companies with property in more than one county and the property of telephone companies operating in more than six counties.

Oil and natural gas production personal property, including drilling rigs (on which a permit fee has been paid), wellheads, and downhole equipment, is exempt from property taxation if the severance tax has been paid on production from the property.[14]

All gathering lines are locally assessed even if they cross county lines. Previously, gathering lines were centrally assessed, but in the 1980s, the Mississippi Supreme

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[11] *Ibid.*

[12] *Ibid.*

[13] Bob Dampeer, Mississippi State Tax Commission, telephone conversation, January 25, 2006.

[14] The exemption for oil production property is under 27-25-523, Mississippi Code, and the exemption for natural gas production property is under 27-25-721, Mississippi Code.

Court ruled that gathering lines were not a public service company.[15] The Mississippi State Tax Commission centrally assesses pipelines that are regulated by the Federal Energy Regulatory Commission or the state. Gathering lines would be centrally assessed if gathering lines are reported to the Federal Energy Regulatory Commission.[16]

Following the Supreme Court decision, the State Tax Commission and representatives of the oil and natural gas industry negotiated the point of assessment for tax purposes for gathering lines. For natural gas lines, property located downstream of the pin recording meter (for measuring the severance tax) is taxable. For oil lines, property located downstream of the holding tank is taxable.[17]

Article 4, Section 112, of the Mississippi Constitution provides for the classification and taxation of property:

- Class I: single family residences are assessed at 10% of true value;
- Class II: all other real property [including railroads and airlines] not included in Class I or Class IV is assessed at 15% of true value;
- Class III: personal property [including railroads and airlines], except for motor vehicles and for personal property included in Class IV, is assessed at 15% of true value;
- Class IV: public utility property, which is property owned or used by public service corporations required by general laws to be appraised and assessed by the state or the county, is assessed at 30% of true value; and
- Class V: motor vehicles are assessed at 30% of true value.

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[15]Bob Dampeer.

[16]Bob Dampeer.

[17]Bob Dampeer.

**Michigan**[18]

The State Tax Commission centrally assesses the property of railroad, telegraph, and telephone companies. The cost, income, and market approaches may be used to value property. However, the market approach is seldom used, and the income approach is used if income is stable over time (ORPS study). Centrally assessed property is subject to a statewide levy in lieu of all other property taxes. The statewide levy is based on the average rate of taxation applied to commercial, industrial, and public utility property. Proceeds from the tax are deposited in the state general fund.

All other property is locally assessed. For the valuation of public utility property, local assessors use multiplier tables developed by the State Tax Commission. The multiplier tables are used to value electric transmission and distribution property and natural gas transmission and distribution lines for property tax purposes. The multipliers convert the original cost or historical cost of transmission property for the year in which the property was installed to the current year value. The multiplier varies depending on the age of the property. The multipliers take into account the income and cost approaches to valuation.[19]

Oil and natural gas gathering lines that serve one project are valued as business machinery and equipment and are subject to lower multipliers (based on shorter economic life). If, however, the gathering lines serve more than one project, that is, if the gathering lines are used to transport third-party oil or natural gas, they are considered public utility property and are valued using the multiplier tables applicable to public utilities.[20]

All property in Michigan is assessed at 50% of market value (211.27a, MCL).

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[18]Timothy Schnelle, Michigan Department of Treasury, Commercial/Industrial Unit, Telephone Conversation, January 29, 2006.

[19]Timothy Schnelle.

[20]Timothy Schnelle.

**Ohio**[21]

In Ohio, public utilities include telephone companies, telegraph companies, electric companies, natural gas companies (distribution companies), pipeline companies, waterworks companies, water transportation companies, natural gas distribution companies, rural electric companies, and railroad companies. The Ohio Department of Taxation uses the unit value method to value public utility property and railroad property. Railroad personal property is valued using the cost and income approach, while public utility personal property is valued using capitalized costs less allowances (ORPS study). Subsidiaries of parent companies cannot file combined reports and are valued separately from the parent company. The method of valuation for the subsidiary would be based on its primary business function.[22]

Most oil and gas production equipment is assessed locally. However, the Department of Taxation centrally assesses the property of a general business, including gathering lines, located in more than one county, regardless of whether the property is continuous. The property is valued at its location and is not apportioned. In tax year 2005, personal property was taxed at 25% of true value. The taxation of general business personal property is being phased out. Beginning in tax year 2009, general business personal property will be exempt from taxation. A portion of the revenue from the newly enacted commercial activities tax will be used to offset the revenue loss to taxing jurisdictions.

Real property, regardless of ownership or use (e.g., residential, commercial, or public utility) is valued locally and is assessed at 35% of true value. The assessment level for utility personal property, on the other hand, is taxed at various assessment levels, ranging from 25% to 88% of true value. For example, the transmission and distribution property of an electrical utility is taxed at 88% of true value and all other property of the utility is taxed at 25% of true value. The transmission and distribution property of a rural electric cooperative is taxed at 50% of true value. The property of natural gas distribution companies and railroad companies is taxed at 25% of true value, while the property of pipeline companies is taxed at 88% of true value.

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[21] Bill Peters, Public Utility Tax Division, Ohio Department of Taxation, telephone conversation, February 7, 2006.

[22] Bill Peters.

Revenue and Transportation

## California[23]

Article 13, section 19, of the California Constitution requires the California Board of Equalization to annually assess:

- pipelines, flumes, canals, ditches, and aqueducts lying within 2 or more counties; and
- property, except franchises, owned or used by regulated railway, telegraph, or telephone companies, car companies operating on railways in the state, and companies transmitting or selling gas or electricity.

The constitutional provisions for the assessment of pipelines limits how the Board of Equalization assesses this type of property. In 1993, the California Supreme Court determined that the Board could assess only pipeline property and not other property owned by the company. As a result, land, improvements, and personal property are locally assessed.

The Board uses the unitary valuation method to value centrally assessed property, using the cost, income, and market approaches. The income approach is given more weight in valuing regulated pipeline property. Unregulated pipelines (including gathering lines) that cross county lines are valued locally by using the replacement cost new, less depreciation method.

Property in California is assessed at 100% of fair market value and taxed at 1% of value. Pipeline property that is annually assessed is not subject to Proposition 13 base year limitations.

## Louisiana

The Louisiana Tax Commission is required to appraise the property of all public service companies. Public service companies include investor-owned electric, gas, water, barge, and telephone companies, pipelines, railroads, airlines, and electric cooperatives. Louisiana statute requires the Tax Commission to use the market approach, income approach, and cost approach, giving the appropriate weight to each approach, to determine fair market value of these properties (RS 47:1853).

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[23] Ken Thompson, Valuation Division, California Board of Equalization, telephone conversation, February 2, 2006.

Revenue and Transportation

Pipeline companies that are regulated by FERC, the Interstate Commerce Commission, or the Louisiana Public Service Commission are centrally assessed by the Tax Commission. Regulated and other subsidiaries of parent companies are valued separately from the parent company.

Oil and natural gas production property, including flow lines and gathering lines (even if they cross parish lines), are valued locally. Local assessors use replacement cost schedules to value intrastate pipelines. Lower quality "lease lines" are valued on a different schedule than higher quality "other pipelines", which include larger gathering lines and transmission lines.[24]

Article VII, section 18(B), of the Louisiana Constitution provides for the classification of property subject to taxation and the percentage of fair market value for determining the assessed valuation of the property:

- land is assessed at 10% of fair market value;
- residential improvements are assessed at 10% of fair market value;
- electric cooperatives, excluding land, are assessed at 15% of fair market value;
- public service properties, excluding land, are assessed at 25% of fair market value;
- other property is assessed at 15% of fair market value.[25]

For tax years 1994 through 2003, several interstate pipeline companies in Louisiana paid property taxes under protest because some intrastate pipelines regulated by the Louisiana Public Service Commission that should have been assessed by the Tax Commission were locally assessed and taxed at 15% of fair market value rather than at 25%. In a consolidated case, a District Court judge ruled that the actions of the Louisiana Tax Commission, as it relates to the plaintiffs, "violated the equal protection clauses and due process clauses of the Louisiana and U.S. Constitutions because of the Commission's disregard of the requirement for uniformity."[26] The Court directed the Tax Commission to require parish assessors to appraise the

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[24] Louisiana Administrative Code, Revenue and Taxation, Title 61, Part V, section 1301.

[25] The Louisiana Constitution also provides for the specific exemption of property from taxation and for sale of property for delinquent taxes.

[26] ANR Pipeline Company v. Louisiana Tax Commission, 19th Judicial District Court, District Court Parish of East Baton Rouge, State of Louisiana, No: 468,417, Sec: 22, March 30, 2005.

plaintiffs' property for the tax years in dispute and assess the property at 15% of value. It also directed the Tax Commission to provide refunds on the difference between the amount of property taxes paid and the reassessed amount.[27]

The plaintiffs appealed the District Court decision to the Court of Appeal, arguing, among other things, that using replacement cost less depreciation would lead to a higher valuation of property than valuing the property on its ability to earn an acceptable (regulated) rate of return. The Tax Commission testified at trial that the unit method of valuation used to value public service property gives different values than locally determined replacement cost.[28] The Appeal Court concluded, based on prior case law, that the appropriate remedy in this case was to use the same valuation and assessment method for the plaintiffs' property as was used for the "preferred properties" (i.e., intrastate pipeline companies), even though that method was contrary to law.[29]

### Alabama[30]

The Alabama Department of Revenue uses the unit value method to value the property of public utilities. Public utilities include, among other entities, the property of railroads, telecommunication and telegraph companies, electric power companies, and water, gas, and pipeline companies. Alabama statute (40-21-6, COA) requires that the Department use the market, income, and cost approaches. The Department gives more weight to the income and cost approaches (ORPS study). Regulated subsidiaries of parent companies are valued as separate units. All other taxable property, including nonoperating property of utilities, is locally assessed even if it crosses county lines.

Taxable property in Alabama is divided into the following classes of property and is assessed at the following ratios of assessed value to the fair and reasonable market value of property:

- Class I: property of utilities used in the utility business, 30%;

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[27] *Ibid.*

[28] ANR v. Louisiana Tax Commission No. 2005 CA 1142, pp. 22-23.

[29] *Ibid.*

[30] Kelly Eggers, Property Tax Division, Alabama Department of Revenue, telephone conversation, February 7, 2006.

- Class II: real and personal property not otherwise classified (includes railroad, airline, and wholesale electrical generation property for tax purposes), 20%;
- Class III: agricultural, forest, and residential property and historic buildings and sites, 10%; and
- Class IV: private autos and pickup trucks not used for hire, rent, or compensation, 15%.

The Alabama Department of Revenue rules provide guidelines for assessing equipment used in the oil and gas industry. Common carrier pipelines transport oil or natural gas from a producer to a user, refiner, or other entity for a fee or tariff. Common carrier pipelines are assessed by the Department as Class I property. Flow lines and gathering lines owned and controlled by the owner or owners of the wells are locally assessed as Class II property. Gathering lines that transport oil or natural gas of persons other that the owners of the wells for a fee or tariff are assessed as common carrier pipelines.[31]

## Concluding Comments

The states included in this survey use a variety of approaches to value public utility property, including oil and natural gas pipelines, as well as oil and natural gas gathering lines. Several states use the unitary valuation method to centrally assess all operating property of public utilities, while some states have variations to that method. For example, Michigan centrally assesses statutorily specified property, which is taxed at the state level only. All other public utility property is locally assessed. Ohio centrally assesses personal property, while all real property is subject to local assessment. A fluke in the California Constitution limits the assessment of pipeline property to personal property. Several states value separately regulated subsidiaries of a parent company.

The states in this survey also use different approaches to value oil and natural gas gathering lines. Wyoming, Mississippi, California, Louisiana, Michigan, and Alabama provide for the local assessment of gathering lines, even if they cross taxing jurisdiction boundaries. Wyoming and Alabama provide for the central assessment of gathering lines under certain conditions, while Michigan values gathering lines that serve more than one project as (locally assessed) utility property. In Ohio, gathering

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[31] Alabama Administrative Code, 810-4-1-.15, Distinction Between Flowlines, Gathering Lines and Pipelines for Assessment of Business Personal Property of the Oil and Gas Industry.

lines that cross county lines are centrally assessed based on location. Kansas, because of the CIG Field Services court decision, is going to have reexamine how it taxes gathering lines.

Kansas, Mississippi, Louisiana, and Alabama tax public utility property at higher rates than other types of property. Ohio has an array of tax rates that apply to public utility property. Wyoming taxes public utility property at the same rate as industrial property. Michigan and California tax all property at the same rate.

# Chapter Six
# Options for Revising the Assessment and Taxation of Oil and Natural Gas Production Property

## Introduction

At its May 2, 2006, meeting, the Revenue and Transportation Committee reviewed information on the HJR 44 study at previous meetings and considered several discussion points on how to deal with the classification, assessment, and taxation of certain oil and natural gas property. The Committee also considered a proposed bill draft from industry that would require the local assessment of certain oil and natural gas production companies. This chapter highlights the discussion points and summarizes the provisions of the industry proposal. Chapter Seven analyzes the property tax revenue implications of the industry proposal.

## Discussion Points

Discussion Point 1

The trial on the Omimex case is scheduled for September 2006. The Committee could suspend any action until the District Court has made a determination. It is possible that a decision could result in a bifurcated valuation scheme in which a portion of Omimex's property could be locally assessed and a portion centrally assessed. Although Judge Sherlock's decision may provide guidance, it is likely that the losing party will appeal to the Montana Supreme Court. In addition, the ruling may not apply to Fidelity or to other companies because of factual differences.

Discussion Point 2

The Committee could consider an approach similar to the introduced version of House Bill No. 569. That is, provide for the local assessment of oil and gas production equipment, including gathering lines. Under this approach, producer gathering lines, if any, "independent" gathering lines, and gathering lines associated with regulated oil or natural gas transmission lines would be locally assessed. This approach would require a clear distinction between gathering lines and transmission lines.

Apparently, there have been no property tax protests on the classification and assessment of gathering lines associated with regulated oil or natural gas transmission lines. This approach could lead, depending on the ownership structure

of the affected property, to part of a company's property being centrally assessed and part of its property being locally assessed. The number of counties affected and the fiscal impact under this approach would be greater than under a more narrowly constructed approach.

Discussion Point 3

The Committee could consider an approach similar to the amended version of House Bill No. 569. That is, provide for the local assessment of oil and gas production facilities, including the producer's flow lines, gathering lines, compressors, and meters, regardless of whether the property is located in more than one county or state. Under the amended version of House Bill No. 569, the producer is the legal entity liable for the oil and gas production taxes under Title 15, chapter 36, MCA.

At least two unintended consequences could arise from this option. First, a transmission company or its affiliated gathering company could acquire oil or natural gas wells resulting in the local assessment of the entity's gathering lines. Second, a locally assessed small, independent gathering company that installs gathering lines that cross county lines would be subject to central assessment and to a higher tax rate. If pursued, this approach should preclude allowing an entity to put in a well in order to qualify the property for locally assessment when it should be centrally assessed. In addition, this approach should ensure that certain gathering lines (e.g., those of small, independent gathering companies) that cross county or state lines are not subject to a higher tax rate.

Discussion Point 4

The Department of Revenue presented a suggested test to the Senate Taxation Committee during the 2005 legislative session and to the Revenue and Transportation Committee at its December 2, 2005, meeting for determining whether certain oil and natural gas property would be locally assessed or centrally assessed.[1] Under the Department's formulation, the following scenarios would apply for determining whether the property is locally assessed or centrally assessed if the property crosses county lines or state lines:

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[1] Gene Walborn, "Valuation of Centrally Assessed Properties", in Minutes, Revenue and Transportation Interim Committee, December 2, 2005, EXHIBIT #2, slides 20-24. The Minutes and links to the exhibits are available on the Committee's webpage at http://leg.state.mt.us/css/committees/interim/2005_2006/rev_trans/default.asp.

**Scenario 1**: If the owner (oil or natural gas producer) of the natural gas or oil pipeline owns 100% of the oil or gas in the pipeline upstream from the point where the oil or gas is in marketable condition,[2] then all property, including but not limited to the pipeline property, is locally assessed.

**Scenario 2**: If the owner (oil or natural gas producer) of the natural gas or oil pipeline does not own 100% of the oil or gas in the pipeline upstream from the point where the oil or gas is in marketable condition, then all property, including but not limited to the pipeline property, is centrally assessed.

**Scenario 3**: If the owner (oil or natural gas producer) of the natural gas or oil pipeline owns any portion of property downstream from the point where the oil or natural gas is in marketable condition, then all of the property is subject to central assessment.

Scenario 1 would likely apply to Encore because its pipeline property apparently is used only for its own production. It would be subject to local assessment even if its pipeline property crossed state or county lines. EnCana, Fidelity, and Omimex would likely continue to be centrally assessed under scenario 2 or 3. The Committee could provide that property upstream of the point of marketable condition that is centrally assessed be reclassified as class eight personal property under 15-6-138, MCA. The Committee would have to take into account the tax treatment of small, independent gathering lines that cross county lines as well as the tax treatment of Bitter Creek's gathering lines. It is possible that the differential tax treatment of small, independent gathering companies and a gathering company such as Bitter Creek could raise problems under the Commerce Clause of the U.S. Constitution.

Discussion Point 5

The Committee could consider codifying ARM 42.22.102(3) related to the central assessment of property. Under that rule, the central assessment of property is "based on the property's operating characteristics such as but not limited to property use, integration of operations, management, and corporate structure".

The second part of this approach would be to reclassify centrally assessed production and gathering property as class eight property, taxed at 3% of market

[2] Under the Department of Revenue's proposal, "marketable condition" means oil or natural gas that is (sufficiently) free from impurities and otherwise in a condition a purchaser will accept under a sales contract typical for the field or area.

value. Under this option, any gathering lines that cross a county line would be centrally assessed but taxed at 3% of market value. Again, a distinction should be made between gathering lines owned by a centrally assessed production company and other types of gathering lines (e.g., Bitter Creek).

### Industry Proposal

Following a review of the discussion points, John Alke, representing Montana-Dakota Utilities, presented a bill draft (LC8000)[3] that would require the local assessment of "legal entities that are primarily oil or gas producers even if their production facilities include flow lines, gathering lines, or injection lines that cross a county or state line." Under the proposal, these companies would be locally assessed and taxed at 3% of market value. At the time of this report, the proposal would apply to EnCana Energy Resources, Inc.; Fidelity Exploration and Production Company; and Omimex Canada, Ltd. The bill draft would also provide for a phased-out reimbursement to local taxing jurisdictions over a 3-year period for the reduction in the tax rate from 12% to 3%.

Jerome Anderson, representing Encore Acquisition, spoke in favor of the bill draft. He told the Committee that increased oil production in eastern Montana and Canada has strained the capacity of interstate oil pipelines operating in that part of the state. If pipeline companies are to expand capacity, they are likely to need help in investing from producers. However, if a producer obtains an ownership interest in an interstate pipeline, the producer may be subject to central assessment and the higher tax rate.[4]

Willie Duffield, representing coal, oil, and natural gas producing counties, said that counties were unsure of what effect the legislation might have on counties and other taxing jurisdiction within the counties.[5]

Dan Bucks, director of the Montana Department of Revenue, said that the proposal could jeopardize the unit valuation approach for valuing integrated operations that cross county or state boundaries. He said that companies could reassign property to

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[3]See Appendix C.

[4]Jerome Anderson, in Minutes, Revenue and Transportation Interim Committee, May 2, 2006, p. 4.

[5]Willie Duffield, in Minutes, Revenue and Transportation Interim Committee, May 2, 2006, p. 5.

closely held businesses organized on county lines to change their property classification and valuation method, resulting in a tax shift to other taxpayers.[6]

[6]Dan Bucks, in Minutes, Revenue and Transportation Interim Committee, May 2, 2006, pp. 5-6.

# Chapter Seven
# Property Tax Implications of Industry Proposal

## Introduction

This chapter quantifies the property tax revenue implications on counties, school districts, and the state if LC8000 were adopted. The tables that follow show for each of the three natural gas producing companies the 2005 estimated taxes for county government levies, state levies (including the university system levy and the 95-mill school equalization levies), public school levies (school district levies and countywide school levies for transportation and retirement) in each county in which the company operates, and the relative importance of the company's taxable value in each taxing jurisdiction. The tables also show the amount of taxes each company would have paid had the proposal been in effect in tax year 2005 and the amount by which mill levies in the local taxing jurisdiction would have to increase to offset the lower property taxes on the company.[7]

The information compiled in the tables was derived from a spreadsheet provided by the Montana Department of Revenue and from mill levies compiled by the Montana Tax Foundation for each taxing jurisdiction. The total amounts of estimated taxes shown in the tables are slightly lower than those calculated by the Department of Revenue in its spreadsheet because the tables may not include miscellaneous taxing jurisdictions. However, the amount of unaccounted revenue is insignificant.

## Encana Energy Resources, Inc.

EnCana operates in Carbon, Golden Valley, and Stillwater Counties. In tax year 2005, its total estimated taxes were $111,954 based on a total taxable value of $285,682.

Carbon County

Most of EnCana's property is located in Carbon County. According to Department of Revenue figures, EnCana's total estimated taxes in Carbon County for tax year 2005 were $72,794 based on a taxable value of $176,778. EnCana accounted for less than 1% of the property tax base in the county and for other county school levies, but

[7] Statewide levies are not included in this analysis because they cannot be increased to raise the same amount of revenue.

accounted for 3.57% of the tax base in the Bridger K-12 school district. Mill levy increases would have been minimal had the proposal been in effect in tax year 2005.

| Carbon County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 110.13 | $19,469 | $4,867 | ($14,601) | 0.69% | 0.17% | 110.70 | 0.5% |
| University levy | 6 | 1,061 | 265 | (796) | NA | NA | NA | NA |
| School equalization | 95 | 16,794 | 4,198 | (12,595) | NA | NA | NA | NA |
| Other county school levies | 47.88 | 8,464 | 2,116 | (6,348) | 0.69% | 0.17% | 48.13 | 0.5% |
| Bridger K-12 | 140.31 | 24,804 | 6,201 | (18,603) | 3.57% | 0.92% | 144.16 | 2.7% |
| Total | 399.32 | $70,591 | $17,648 | ($52,943) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Golden Valley County

According to Department of Revenue figures, EnCana's total estimated taxes in Golden Valley County for tax year 2005 were $10,210 based on a taxable value of $29,124. EnCana accounted for less than 1% of the property tax base in each of the taxing jurisdictions in the county. Mill levy increases would have been minimal had the proposal been in effect in tax year 2005.

| Golden Valley County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 83.76 | $2,439 | $610 | ($1,830) | 0.58% | 0.15% | 84.13 | 0.4% |
| University levy | 6 | 175 | 44 | (131) | NA | NA | NA | NA |
| School equalization | 95 | 2,767 | 692 | (2,075) | NA | NA | NA | NA |
| Other county school levies | 37.87 | 1,103 | 276 | (827) | 0.58% | 0.15% | 38.04 | 0.4% |
| Ryegate K-12 | 125.71 | 3,661 | 915 | (2,746) | 0.88% | 0.22% | 126.55 | 0.7% |
| Total | 348.34 | $10,145 | $2,536 | ($7,609) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Stillwater County

According to Department of Revenue figures, EnCana's total estimated taxes in Stillwater County for tax year 2005 were $28,951 based on a taxable value of $79,780. EnCana accounted for less than 1% of the property tax base in the county and for other county school levies, but accounted for a little over 2% of the property tax base in the Rapelje elementary school district and a little under 2% in the Rapelje

high school district. Mill levy increases would have been minimal had the proposal been in effect in tax year 2005.

| Stillwater County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 115.18 | $9,189 | $2,297 | ($6,892) | 0.27% | 0.07% | 115.42 | 0.2% |
| University levy | 6 | 479 | 120 | (359) | NA | NA | NA | NA |
| School equalization | 95 | 7,579 | 1,895 | (5,684) | NA | NA | NA | NA |
| Other county school levies | 33.74 | 2,692 | 673 | (2,019) | 0.27% | 0.07% | 33.81 | 0.2% |
| Rapelje Elementary | 55.51 | 4,429 | 1,107 | (3,321) | 2.12% | 0.54% | 56.41 | 1.6% |
| Rapelje High School | 57.46 | 4,584 | 1,146 | (3,438) | 1.86% | 0.47% | 58.27 | 1.4% |
| Total | 362.89 | $28,951 | $6,092 | ($22,860) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

### Fidelity Exploration and Production Company

Fidelity owns property in Big Horn, Fallon, Phillips, and Valley Counties. The property valuation of Fidelity is included in the valuation of Williston Basin Interstate Pipeline. In tax year 2005, Fidelity's total estimated taxes were $275,145 based on a total taxable value of $1.1 million. The company has minimal presence in Valley County ($4,524 total estimated taxes); Valley County is not included in the discussion below. County allocations of property attributable to Fidelity were provided by the Department of Revenue.

Big Horn County

Fidelity's total estimated taxes in Big Horn County for tax year 2005 were $198,991. Fidelity accounted for 13.64% of the tax base in the Spring Creek elementary school district but a much smaller amount in the other taxing jurisdictions. Under the proposal, total property taxes would be $149,243 less. In order to offset the property tax reduction, mill levies would increase a little over 3% in most taxing jurisdictions. However, the mill levy in the Spring Creek elementary school district would increase by 11.4%, going from 2.9 mills to 3.23 mills.

| Big Horn County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 80.14 | $61,224 | $15,306 | ($45,918) | 3.97% | 1.02% | 82.60 | 3.1% |
| University levy | 6 | 4,584 | 1,146 | (3,438) | NA | NA | NA | NA |
| School equalization | 95 | 72,577 | 18,144 | (54,433) | NA | NA | NA | NA |
| Other county school levies | 27.16 | 20,749 | 5,187 | (15,562) | 3.97% | 1.02% | 27.99 | 3.1% |
| Spring Creek Elementary | 2.9 | 2,216 | 554 | (1,662) | 13.64% | 3.80% | 3.23 | 11.4% |
| Hardin High School | 49.27 | 37,641 | 9,410 | (28,231) | 4.65% | 1.20% | 51.05 | 3.6% |
| Total | 260.47 | $198,991 | $49,748 | ($149,243) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Fallon County

Fidelity's total estimated taxes in Fallon County for tax year 2005 were $50,294 based on a taxable value of $217,140. Fidelity is relatively insignificant to the property tax base in the county. In addition, neither of the K-12 school districts imposed any mill levies in tax year 2005. Under the proposal, total property taxes would be $37,720 less.

| Fallon County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 130.62 | $28,363 | $7,091 | ($21,272) | 1.70% | 0.43% | 132.31 | 1.3% |
| University levy | 6 | 1,303 | 326 | (977) | NA | NA | NA | NA |
| School equalization | 95 | 20,628 | 5,157 | (15,471) | NA | NA | NA | NA |
| Other county school levies | 0 | - | - | - | NA | NA | NA | NA |
| Baker K-12 | 0 | - | - | - | 2.24% | 0.57% | 0.00 | NA |
| Plevna K-12 | 0 | - | - | - | 0.19% | 0.05% | 0.00 | NA |
| Total | 231.62 | $50,294 | $12,573 | ($37,720) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Phillips County

Fidelity's total estimated taxes in Phillips County for tax year 2005 were $21,554 based on a taxable value of $84,320. Fidelity is relatively insignificant to the property tax bases in the county. Under the proposal, total property taxes would be $16,166 less.

| Phillips County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| **County** | 77.52 | $6,536 | $1,634 | ($4,902) | 0.61% | 0.15% | 77.88 | 0.5% |
| **University levy** | 6 | 506 | 126 | (379) | NA | NA | NA | NA |
| **School equalization** | 95 | 8,010 | 2,003 | (6,008) | NA | NA | NA | NA |
| **Other county school levies** | 41 | 3,457 | 864 | (2,593) | 0.61% | 0.15% | 41.19 | 0.5% |
| **Saco Elementary** | 18.18 | 1,638 | 409 | (1,228) | 2.59% | 0.66% | 18.54 | 2.0% |
| **Saco High School** | 16.68 | 1,406 | 352 | (1,055) | 2.39% | 0.61% | 16.98 | 1.8% |
| **Total** | 254.38 | $21,554 | $5,389 | ($16,166) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Omimex Canada, Ltd

Omimex owns property in Blaine, Glacier, Hill, Liberty, Phillips, Silver Bow, Toole, and Valley Counties. In tax year 2005, its total estimated taxes were $1.08 million based on a total taxable value of $2.2 million. The company has minimal presence in Hill County ($566 total estimated taxes), Silver Bow County ($14,927 total estimated taxes), and Valley County ($743 total estimated taxes); these counties are not included in the discussion below.

Blaine County

According to Department of Revenue figures, Omimex's total estimated taxes in Blaine County for tax year 2005 were $136,282 based on a taxable value of $286,828. The property of Omimex accounted for less than 2.4% of the property tax base in the county and in the Zurich elementary school district and for other county school levies, but accounted for 7.48% of the tax base in the Chinook elementary school district and a little over 3.95% in the Chinook high school district. Mill levy increases for the county, other county school levies, and Zurich elementary school would have been minimal had the proposal been in effect in tax year 2005. The mill levy for Chinook elementary school would have increased by 5.9% and the mill levy for the Chinook high school district by 3%.

| Blaine County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 168.77 | $48,408 | $12,102 | ($36,306) | 2.41% | 0.61% | 171.88 | 1.8% |
| University levy | 6 | 1,721 | 430 | (1,291) | NA | NA | NA | NA |
| School equalization | 95 | 27,249 | 6,812 | (20,436) | NA | NA | NA | NA |
| Other county school levies | 42.66 | 12,236 | 3,059 | (9,177) | 2.41% | 0.61% | 43.45 | 1.8% |
| Chinook Elementary | 141.11 | 38,539 | 9,635 | (28,904) | 7.48% | 1.98% | 149.50 | 5.9% |
| Zurich Elementary | 21.03 | 288 | 72 | (216) | 0.84% | 0.21% | 21.16 | 0.6% |
| Chinook High School | 34.43 | 9,875 | 2,469 | (7,407) | 3.95% | 1.02% | 35.48 | 3.0% |
| Total | NA | $138,317 | $34,579 | ($103,737) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Glacier County

According to Department of Revenue figures, Omimex's total estimated taxes paid in Glacier County for tax year 2005 were $596,561 based on a taxable value of $1,045,485. The relative importance of property owned by Omimex in the taxing jurisdictions ranges from 5.6% in the Cut Bank high school district to 8.3% in the Browning elementary school district. Under the proposal, total property taxes would be $444,237 less. Mill levies would have increased for most taxing jurisdictions by 4.4% to 4.9% had the proposal been in effect in tax year 2005. The mill levy in the Browning elementary school district would increase by 6.6%.

| Glacier County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 172.01 | $179,834 | $44,958 | ($134,875) | 5.87% | 1.53% | 179.93 | 4.6% |
| University levy | 6 | 6,273 | 1,568 | (4,705) | NA | NA | NA | NA |
| School equalization | 95 | 99,321 | 24,830 | (74,491) | NA | NA | NA | NA |
| Other county school levies | 59.67 | 62,384 | 15,596 | (46,788) | 5.87% | 1.53% | 62.42 | 4.6% |
| Browning Elementary | 209.46 | 92,406 | 23,101 | (69,304) | 8.27% | 2.20% | 223.31 | 6.6% |
| Browning High School | 85.06 | 37,525 | 9,381 | (28,144) | 6.28% | 1.65% | 89.27 | 4.9% |
| Cut Bank Elementary | 109.1 | 65,932 | 16,483 | (49,449) | 5.65% | 1.47% | 113.92 | 4.4% |
| Cut Bank High School | 80.49 | 48,642 | 12,160 | (36,481) | 5.6% | 1.5% | 84.02 | 4.4% |
| Total | | $592,317 | $148,079 | ($444,237) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Liberty County

According to Department of Revenue figures, Omimex's total estimated taxes in Liberty County for tax year 2005 were $146,283. The relative importance of property owned by Omimex in the taxing jurisdictions ranges from 3.79% in the Chester joint high school district to 4.54% in the county. The tax base for the Chester school districts includes property in Hill County. Under the proposal, total property taxes would be $109,639 less. Mill levies would have increased by 2.9% to 3.5% had the proposal been in effect in tax year.

| Liberty County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 211.8 | $65,935 | $16,484 | ($49,452) | 4.54% | 1.18% | 219.27 | 3.5% |
| University levy | 6 | 1,868 | 467 | (1,401) | NA | NA | NA | NA |
| School equalization | 95 | 29,574 | 7,394 | (22,181) | NA | NA | NA | NA |
| Other county school levies | 28.37 | 8,832 | 2,208 | (6,624) | 4.54% | 1.18% | 29.37 | 3.5% |
| Chester-Joplin-Inverness | 78.93 | 24,572 | 6,143 | (18,429) | 3.97% | 1.02% | 81.35 | 3.1% |
| Chester-Joplin-Inverness | 49.48 | 15,404 | 3,851 | (11,553) | 3.79% | 0.98% | 50.93 | 2.9% |
| Total | 469.58 | $146,185 | $36,546 | ($109,639) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

## Phillips County

According to Department of Revenue figures, Omimex's total estimated taxes in Phillips County for tax year 2005 were $141,809 based on a taxable value of $416,190. Omimex accounted for less than 1% of the tax base in the Saco school district, 3.03% in the county, and 10.87% in the Whitewater K-12 school district. Under the proposal, total property taxes would be $103,555 less. Mill levies would have increased by 0.7% to 8.9% had the proposal been in effect in tax year 2005.

| Phillips County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % of Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 77.52 | $32,263 | $8,066 | ($24,197) | 3.03% | 0.77% | 79.32 | 2.3% |
| University levy | 6 | 2,497 | 624 | (1,873) | NA | NA | NA | NA |
| School equalization | 95 | 39,538 | 9,885 | (29,654) | NA | NA | NA | NA |
| Other county school levies | 41 | 17,064 | 4,266 | (12,798) | 3.03% | 0.77% | 41.95 | 2.3% |
| Whitewater K-12 | 118.69 | 45,594 | 11,399 | (34,196) | 10.87% | 2.96% | 129.23 | 8.9% |
| Saco Elementary | 18.18 | 583 | 146 | (437) | 0.92% | 0.23% | 18.31 | 0.7% |
| Saco High School | 16.68 | 535 | 134 | (401) | 0.91% | 0.23% | 16.79 | 0.7% |
| Total | NA | $138,073 | $34,518 | ($103,555) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Toole County

According to Department of Revenue figures, Omimex's total estimated taxes in Toole County for tax year 2005 were $46,440. Property owned by Omimex is relatively unimportant in the taxing jurisdictions in the county. Omimex accounts for 2.34% of the tax base in the Galata elementary school district. Under the proposal, total property taxes would be $33,013 less. Mill levy increases to offset the loss would be insignificant.

| Toole County | 2005 Mill Levy | 2005 Est. Taxes | Proposal Taxes | Difference | 2005 Tax Value as % of Total | Proposal Tax Value as % ot Total | Mill Levy to Raise Same Amount | Percent Increase |
|---|---|---|---|---|---|---|---|---|
| County | 145.38 | $18,161 | $4,540 | ($13,621) | 0.94% | 0.24% | 146.41 | 0.7% |
| University levy | 6 | 750 | 187 | (562) | NA | NA | NA | NA |
| School equalization | 95 | 11,868 | 2,967 | (8,901) | NA | NA | NA | NA |
| Other county school levies | 13.13 | 1,640 | 410 | (1,230) | 0.94% | 0.24% | 13.22 | 0.7% |
| Sunburst K-12 | 97.55 | 5,591 | 1,398 | (4,193) | 1.16% | 0.29% | 98.41 | 0.9% |
| Shelby Elementary | 168.58 | 1,308 | 327 | (981) | 0.13% | 0.03% | 168.75 | 0.1% |
| Galata Elementary | 3.97 | 238 | 59 | (178) | 2.34% | 0.59% | 4.04 | 1.8% |
| Shelby High School | 66 | 4,462 | 1,116 | (3,347) | 0.8% | 0.2% | 6640.0% | 0.6% |
| Total | NA | $44,017 | $11,004 | ($33,013) | NA | NA | NA | NA |

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

The table below summarizes the property tax revenue implications of the proposal. The revenue effect on county governments and on school districts is about the same at around $353,800. The effect on state and county school equalization is about $252,000, while the effect on other school levies (countywide transportation and retirement) is about $104,000. The effect on the university system is about $16,000.

| Summary of the Effects of Reducing the Tax Rate on Natural Gas Production Property | | | | |
|---|---|---|---|---|
| Taxing Entity | EnCana | Fidelity | Omimex | Total |
| County | $23,323 | $72,093 | $258,451 | $353,867 |
| University system | 1,286 | 4,794 | 9,831 | 15,911 |
| School equalization (state general fund) | 20,355 | 75,912 | 155,622 | 251,929 |
| Other school levies | 9,194 | 18,155 | 76,617 | 103,966 |
| School districts | 28,108 | 32,175 | 293,473 | 353,757 |
| Total | $82,266 | $203,129 | $794,035 | $1,079,430 |

The total effect on local taxing jurisdictions is about $811,590. This amount is slightly understated because of the counties that were not included in the analysis. Section 15-10-420, MCA, allows local taxing jurisdictions to impose mill levies to raise the same amount of property taxes actually assessed in the previous year. This provision does not apply to statewide mill levies. Each year, the Department of Revenue calculates, on a statewide basis, the number of mills to be imposed for statewide levies. However, levies may not exceed the statutory maximum. As such, revenue losses typically could not be offset by raising these levies.

If the proposal were adopted, the effect on local taxing jurisdictions would vary depending on the relative importance of the property in the taxing jurisdiction. The relative importance of the affected property to a particular jurisdiction does not correspond to the relative proportion of the property to the total financial resources of the taxing jurisdiction. Taxing jurisdictions receive oil and natural gas production revenue, other nonlevy revenue, and entitlement share payments under 15-1-121, MCA.

The proposal would have other revenue implications. Railroad and airline property classified under 15-6-145, MCA (class twelve property), is taxed at the average statewide commercial tax rate. Reducing the tax rate on natural gas property would reduce the tax rate applied to class twelve property. The fiscal note on House Bill No. 569 from the 2005 session estimated a state general fund reduction of between $22,000 and $23,000. The effect on local taxing jurisdictions would be minimal.

According to the fiscal note for the amended version of House Bill No. 569, the reduction in the taxable value of the affected property would have caused a one-time increase in guaranteed tax base aid for school districts and countywide school retirement of $102,622.

# Chapter Eight
# Conclusion

Following the discussion of property tax implications of the industry proposal, the Committee decided not to take action on the industry proposal. Senator Jim Elliott, Committee chair, suggested that it would be appropriate for the court system to settle the issue. The Committee was concerned both about tax fairness and ensuring that property tax burdens are not shifted to other taxpayers.

As noted earlier, the industry proposal, notwithstanding any unintended consequences, would only affect, at this time, three natural gas production companies. Because of the different factual circumstances involving each company, it is difficult to assess whether a court decision in the Omimex case would apply to the property of Fidelity or EnCana, or both. However, an appeal of the Omimex case in which the Montana Supreme Court upheld Judge Jeffrey Sherlock's determination that administrative rule 42.22.102(3) is an invalid rule (see footnote 8, Chapter 2) could lead to the local assessment of Fidelity.

At some point, the Legislature may have to deal with the complex issues raised by this study. In large part, the central assessment of property has been associated with regulated utilities and other industries. Typically, property taxes paid by utilities are passed on to customers in the rate base. However, the dynamics of natural gas markets have changed significantly over the last few decades beginning with the gradual deregulation of wellhead prices at the federal level in 1978. In 1992, the Federal Energy Regulatory Commission issued Order No. 636 to require natural gas pipeline companies to provide open access for transmission services and to separate its production and gathering operations. In 1997, the Montana Legislature enacted Senate Bill No. 396 (Ch. 506, L. 1997) to require a natural gas utility that provides customer choice and open access to "functionally separate its natural gas production and gathering from its natural gas transmission, storage, and distribution services and remove natural gas production from the rate base."

The initial buyer of a large portion of the former Montana Power Company's property has in turn sold it to Omimex. In addition, small natural gas producers have acquired other parts of MPC's property. Other acquisitions and the merger of companies,

including oil production and pipeline property, has also occurred over the last several years and will likely continue in the future.

The Legislature should discuss the appropriate method of assessment and tax rates in a changing market structure, taking into account the equitable treatment of taxpayers, avoiding unintended consequences, and maintaining the integrity of the central assessment process.

# Part Two

## Overview of Business Income Taxation

# Chapter Nine
# Overview of Corporation Income Taxes

In order to develop a better understanding of Montana's tax systems, the Revenue and Transportation Committee's work plan contained a staff recommendation that the Committee review and analyze at least one major tax source each interim. The goal is to provide a reference source for legislators, policymakers, and the public.

During the 2005 legislative session, several bills were introduced that dealt with some aspect of the corporation license tax. In particular, Senate Bill No. 513 was introduced to provide for compliance measures for income taxes and corporate license taxes. The bill passed the Senate but was tabled in the House Taxation Committee because there was concern that the bill had been introduced so late in the session that sufficient time was not available to adequately deal with the implications of the proposal. Given the current interest in business income taxes, it would be timely to review and analyze business income taxes and corporate license taxes.

This chapter discusses some of the concepts, principles, and practices related to corporation income taxes. It provides a brief overview of the imposition of state corporation income taxes, the rationale for taxing corporations, the history of the tax in Montana, and some interstate tax comparisons.

### Introduction

Montana is one of 44 states and the District of Columbia that taxes the net income of corporations. Michigan, Texas, and Washington do not tax corporations on the basis of net income. Michigan imposes a single business tax, which is a modified value-added tax, and Washington imposes a business and occupation tax based on gross receipts (the rate varies by type of business). Texas imposes a corporate franchise tax calculated on the greater of 0.25% of apportioned net worth or 4.5% of apportioned earned surplus. Beginning in 2008, Texas will impose a new tax based on "taxable margin". Nevada, South Dakota, and Wyoming do not impose individual or corporation income taxes. South Dakota taxes only financial institutions on the basis of net income.

Three states have recently made significant changes to their corporation or business tax structure. In 2005, Ohio enacted a commercial activity tax (gross receipts tax)

that will replace the current corporation franchise tax (taxes are currently paid on the higher of net income or net worth). The new tax is imposed only on commercial activities regardless of business entity form. The tax is phased in over a 5-year period.[1] Michigan enacted the single business tax in 1975 to replace several separately imposed taxes on business. The state, apparently growing weary of the tax, planned to phase out the tax by 2009. However, this summer the Michigan Legislature approved a voter initiative to repeal the tax beginning after December 31, 2007. The Michigan Legislature has not yet decided on a replacement tax or expenditure cuts to offset the repeal.[2]

In response to a Texas Supreme Court ruling that the state's funding of public schools was unconstitutional, the Texas Legislature, among other things, significantly revised the taxation of businesses. Under the existing tax structure, only for-profit corporations and limited liability companies, including those organized within the state, and foreign corporations and LLCs doing business in the state were subject to tax. The tax does not apply to limited partnerships, sole proprietorships, or noncorporate associations. The existing tax structure practically begged corporate entities to reorganize to avoid the tax. The new law revises the calculation of the franchise tax and expands the types of business entities subject to the tax. Taxable entities include corporations, limited liability companies, partnerships, professional associations, and other legal entities, except sole proprietorships, general partnerships owned by a natural person, and nonprofit organizations. The tax rate is 1% (or 0.5% if the entity is a retailer or wholesaler) of the business's taxable margin. The taxable margin is determined by subtracting cost of goods sold or total compensation from total revenue. The new law also requires that a unitary group must file a combined return.[3] Combined reporting is discussed later.

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[1]For a mind-boggling discussion of Ohio's commercial activity tax, see "CAT Got Your Tongue? Navigating the Complexities of Ohio's New Commercial Activity Tax", KPMG, http://www.us.kpmg.com/microsite/tax/salt/perspectives/Fall_2005-02.asp.

[2]Plante & Moran, PLLC, "Michigan Single Business Tax Repeal Accelerated to December 31, 2007", SALT Tax Alert, August 10, 2006. Retrieved September 1, 2006, from http://www.plantemoran.com/Services/Tax/TaxConsulting/Resources/SALT+Alert/Michigan/Michigan+Single+Business+Tax+Repeal+Accelerated.htm.

[3]Greenberg Traurig, LLP, "The New Texas Franchise Tax", June 2006. Retrieved September 1, 2006, from www.gtlaw.com/pub/Alerts/2006/0601.pdf.

Taxes on corporate net income differ significantly among the states in terms of definitions of taxable income, tax rates, the taxable entity, and the apportionment of taxable income of corporations that operate in more than one state.

## Corporations Taxed Early in the Last Century

Montana was one of six states (Connecticut, 1915, Missouri, 1917, Montana, 1917, New York 1917, Virginia, 1915, Wisconsin, 1911, and the Territory of Hawaii, 1901) to impose a corporation income tax by 1917.[4] According to David Brunori, the early spread of state taxation of the income of corporations came by dint of progressive and populist political leaders with a skeptical view of corporations.[5] "The opportunity to raise revenue from corporations fit naturally with their political philosophies."[6]

By 1930, 10 additional states had adopted the tax, with 15 states joining the ranks in the 1930s. Two states adopted the tax in the late 1940s, one in 1958, and nine between 1963 and 1971. Many states also imposed an individual income tax at the same time as the corporation income tax or the taxes were imposed within a few years of each other.[7]

The tax on corporations was only one component of expanding and diversifying state tax revenue for states that had relied almost exclusively on property and excise taxes. The diversification was particularly evident in the 1930s. During that decade, 24 states first imposed general sales taxes, 17 states (including Montana in 1933) imposed individual income taxes, 19 states taxed cigarettes, and 27 states taxed alcoholic beverages.

## Rationale for Taxing the Income of Corporations

Disenchantment with corporations and the desire to diversify state tax revenue notwithstanding, there are several rationales for taxing the net income of corporations. The first is to protect the individual income tax base by including certain

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[4] In 1909 Congress imposed a corporate excise tax of 1% on income over $5,000. It was considered an indirect tax on the privilege of doing business.

[5] Interestingly, Mike Malone makes no mention of the Montana corporation income tax in his chapter on the progressive era in Montana in Montana, A History of Two Centuries.

[6] Brunori, David, State Tax Policy, A Political Perspective, (The Urban Institute Press, Washington D.C., 2001), p. 105.

[7] Connecticut did not adopt a broad-based individual income tax until 1991.

corporate income, such as retained earnings, in the corporation tax base. If corporate income were not taxed, shareholders could hide income within the corporation. However, shareholders are subject to double taxation when dividends are paid.

Another rationale for the taxation of corporations is the benefits-received principle.[8] At the local level, corporations pay property taxes for police and fire protection as well as educational services. At the state level, they pay for such things as transportation infrastructure and the legal system. Shareholders of the corporation benefit from public services, and the corporation tax provides a means of assessing a tax on those beneficiaries.[9] However, a tax on net income may not coincide with the value of the service received. Other taxes, such as a value-added tax or a gross receipts tax, may be better way to tax for benefits received. Under these types of taxes, businesses, whether profitable or unprofitable, would pay the tax for benefits received.

A third rationale is that the corporation tax offsets disparities in the property tax. Businesses that are more capital-intensive (e.g., manufacturing) are taxed more heavily under the property tax than are labor-intensive businesses (e.g., high-technology). The corporation income tax mitigates differences in property tax treatment of business inputs.[10]

### The Taxation of Corporations in Montana

The initial rate imposed on corporations doing business in Montana was 1% of net income. Since then, the Montana Legislature increased the tax rate six times. During the second extraordinary session of the 42nd Legislature, the tax rate was temporarily increased from 6.25% (the rate was 5.5% in 1968) to 6.75% (Ch. 7, 2nd Ex. L. 1971). The higher tax rate was effective for tax years 1971 and 1972, after which it would fall to 6.25%. The tax rate would have been 6.25% in tax year 1972, had the electorate approved Referendum No. 68 (Ch. 9, 2nd Ex. L. 1971) to impose

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[8] The benefits-received principle is the equity viewpoint that persons who receive benefits from goods and services provided by government should bear the tax burden in proportion to benefits received. By contrast, the ability-to-pay principle is the equity viewpoint that the amount of tax burden should be related to a person's economic ability to bear the burden.

[9] Coffey, Sarah Beth, "The Questionable Link Between State Corporate Income Taxes and Economic Development", *State Tax Notes*, Vol. 38, No. 3 (Falls Church, VA: October 10, 2005), p. 213.

[10] Brunori, *op. cit.*, p. 106. Based on an interview (Brunori) with Dan Bucks, director, Multistate Tax Commission, *State Tax Notes*, Volume 9, No. 5, July 31, 2000.

a 2% general sales tax and reduce the 40% surtax on individual income to 10%. The referendum failed by more than a 2-to-1 margin. In 1974, the Legislature made permanent the 6.75% tax rate (Ch. 5, L. 1974). The legislation also specifically provided for the apportionment of income of multistate or multinational corporations. Up until that time, the apportionment of income was based on rules adopted by the former state Board of Equalization.

In accordance with the Multistate Compact, multistate or multinational corporations required to file a return whose only activity in the state consists of making sales and that do not own or rent real or personal property in the state and whose gross receipts do not exceed $100,000 may elect to pay a gross receipts tax of 1/2 of 1% (15-31-122, MCA).[11]

In 1987, the Legislature allowed multinational corporations doing business in Montana to elect water's-edge taxation based on income earned in the United States (Ch. 616, L. 1987). Beginning in tax year 2004, the income of a water's-edge taxpayer must include the income of a corporation in a unitary relationship with the taxpayer that is incorporated in a tax haven (Ch. 521, L. 2003). The tax rate for a corporation electing water's-edge is 7%.

In the 1989 special session, the Legislature required a corporation to make estimated tax payments if its annual estimated tax is $5,000 or more (Ch. 9, Sp. L. June 1989). One reason for requiring estimated tax payments was to accelerate the collection of corporation taxes to help offset the unfunded liability in workers' compensation.

## Corporation Tax Bases and Rates

Most states that impose a corporation income tax are tied to the federal tax code. Conformity with federal tax laws simplifies compliance with and the administration of the corporation income tax. Many states use federal Form 1120 net federal taxable income (line 30) or federal taxable income before net operating loss and special

[11] The compact provides that the Multistate Tax Commission, not more than once in 5 years, may adjust the $100,000 figure to reflect changes in the real value of the dollar (15-1-601, MCA).

deductions (line 28) as the starting point for determining a corporation's state tax liability.[12] Total federal income of a corporation is determined as follows:

- gross receipts (less returns and allowances) - cost of goods sold = gross profit
- gross profit + dividends and interest + gross rents and royalties + capital gain net income + net gain or (loss) from sale of business property + other income = total income (line 11)

Federal taxable income (line 28 of the federal tax return) is determined by subtracting operating expenses and other deductions (e.g., compensation of officers, employee wages and salaries, bad debts, taxes and licenses, depreciation, and charitable contributions) from total income. Federal taxable income may be further reduced by net operating loss deductions and special deductions (line 30 on the federal return). Although states generally conform with federal tax laws, they may make modifications to taxable federal income that reflect differences from federal policy. For example, a state may "decouple" from certain federal tax provisions in order to maintain the state's tax base.[13]

Additions and subtractions to corporate federal taxable income vary significantly among the states. Additions may include the following:

- interest income from state and local debt obligations;
- other state, local, and foreign income taxes paid;
- federal carryover deductions for net operating losses;
- federal dividends-received deductions;
- federal bonus depreciation;
- royalty and interest expenses paid to related parties;
- expenses related to state tax credits;
- section 199 qualified production activities income deduction (see footnote 13);
- expenses related to income that is exempt for state tax purposes.

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[12] Healy, John C. and Michael S. Schadewald, 2005 Multistate Corporate Tax Guide, Vol 1. (Chicago: CCH Incorporated, 2005), p. I-11.

[13] For example, 31 states decoupled from the "bonus depreciation" provision of the Jobs and Growth Tax Relief Reconciliation Act of 2003, and 18 states decoupled from the "qualified production activities deduction" provision of the American Jobs Creation Act of 2004.

Some subtractions from federal taxable income may include:

- interest received on federal debt obligations;
- state net operating deductions;
- state dividends-received deductions;
- expenses related to federal tax credits;
- federal gross-up income with respect to foreign subsidiaries.[14]

States that are not tied directly to the federal tax base may incorporate federal income and deduction provisions (e.g., Minnesota). Arkansas defines income and allowable deductions in state law. Twenty-eight states (including Montana) and the District of Columbia impose a flat rate on net income and the remainder impose graduated rates. Some states impose separate tax rates on financial institutions and other types of businesses. Pennsylvania also imposes a capital stock tax, a foreign franchise tax, and a corporate loans tax.

In 1961, the Montana Legislature specifically adopted the federal definition of gross income to include the income from all sources within the state that is recognized in the determination of the corporations's federal income tax liability (Ch. 235, L. 1961).[15] Federal taxable income (line 28, excluding federal net operating losses and special deductions) is the starting point for determining Montana taxable income. Several items are added to and subtracted from the federal base to determine Montana taxable income. Additions to federal taxable income in Montana include:

- Montana corporation license tax included in federal taxable income;
- other state, local, and foreign income taxes;
- federally exempt municipal interest;
- contributions used to compute Montana's tax credit for a contribution to a qualified endowment under 15-31-161, MCA;
- extraterritorial income exclusion;[16]
- capital loss carryover and other additions.

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[14] Healy and Schadewald, *op. cit.*, p. I-13.

[15] Gross income is now defined as "all income recognized in determining the corporation's gross income for federal income tax purposes" (with adjustments).

[16] The extraterritorial income exclusion was repealed by the American Jobs Creation Act of 2004 because the World Trade Organization declared that the exclusion is illegal under international law.

Subtractions include:

- Internal Revenue Code "Section 243" dividends received deduction;
- certain nonbusiness income (nonbusiness income is taxed in the state in which it is earned);
- other deductions (e.g., current year capital loss).[17]

## Net Operating Loss Carryforward and Carryback

Corporations are allowed to reduce taxable income by carrying back or carrying forward net operating losses. A net operating loss occurs when a business's deductions exceed its operating income for the tax year. The rationale for allowing net operating losses is to tax businesses on the basis of the business cycle rather than individual tax years; the taxpayer is allowed to offset its bad years against its good years with net operating losses. A carryback of a net operating loss generally results in a tax refund in the carryback year, while a carryforward generally reduces tax liability in the carryforward year. In Montana, the carryback period is 3 years and the carryforward period is 7 years (15-31-119, MCA). A taxpayer may elect to forgo the carryback period for the tax year of the net operating loss.

For federal income tax purposes, a corporation is allowed to carry back losses 2 years and carry forward 20 (previously 3 years back and 15 years forward). The Job Creation and Worker Assistance Act of 2002 temporarily extended the 2-year carryback to 5 years for net operating losses incurred in 2001 and 2002. Although several states conform to the federal provisions, most states have adopted their own provisions by eliminating carrybacks, establishing shorter periods, or limiting the dollar amount allowed in a given year. Twenty-four states do not allow net operating loss carrybacks. Illinois and Nebraska previously conformed with federal rules. Illinois now allows a 12-year carryforward period and Nebraska allows a 5-year carryforward. Nineteen states (including Montana) and the District of Columbia allow carrybacks (2-5 years) and carryforwards (5-20 years). Vermont follows federal provisions for net operating losses but does not allow a refund for a net operating loss carryback; the effect is to reduce the amount of the net operating loss that may be carried forward.

[17] The additions and subtractions are derived from "Overview of Montana Corporation License Tax", presented by Brian Staley, Department of Revenue, to the Legislative Interim Tax Reform Study Committee, June 14, 2004, and to the Revenue and Transportation Committee, July 9, 2004.

## Apportionment of Income

A significant amount of state corporation income taxes are paid by multistate or multinational corporations. The income of a corporation that operates in more than one state or country is apportioned for tax purposes to each state in which the corporation operates. The apportionment of income formula is the ratio of the corporation's business activity in the state to the corporation's total business activity. Adjusted federal taxable income is apportioned to each state according to its apportionment formula. The apportionment formula typically includes in-state sales to total sales, in-state payroll to total payroll, and in-state property to total property of the corporation.[18] These factors serve as a proxy for benefits received by a corporation doing business in a state and thus the amount of tax a state can impose for those benefits.[19] The formula is used to ensure that a corporation's overall business activity is properly assigned to each state in which it operates. States that calculate the taxable income and apportionment percentage of a parent corporation without regard to its subsidiaries are known as separate entity states. States that take into account the income and apportionment of parent companies and subsidiaries are known as combined unitary reporting states.

Separate Reporting: Under separate reporting, each corporation pays tax only on its own income regardless of its connection with other corporations.[20] The taxable income of each corporation or legal entity is apportioned to those states in which it operates. In separate entity states, tax revenue may be affected by corporate restructuring, transfer pricing, and the creation of holding companies. These tax strategies may result in shifting income or profits to low tax states or to states that do not tax corporate income ("nowhere income"). Many states (including combined reporting states) have a "throwback rule" that allocates sales to the state of origin if the seller is not taxable in the destination state. Under certain conditions, some states may require consolidated or combined reporting (if separate reporting does not adequately account for income) or grant permission to the taxpayer to file combined reporting.

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[18] In-state mileage to total mileage may be included in the apportionment formula for businesses that transport persons or property.

[19] Atkins, Chris, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems", Background Paper No. 49 (Washington, D.C.:Tax Foundation, 2005), p. 6. Retrieved from http://www.taxfoundation.org/news/
show/1096.html, October 11, 2005.

[20] *Ibid.*, p. 4.

Combined Reporting: Under combined reporting, a commonly controlled group of corporations engaged in a unitary business computes state taxable income on a combined basis. A unitary business is generally one that has unity of ownership, unity of operation, and unity of use.[21] This method of reporting income allows members of the unitary business to offset profits of an affiliate with losses of other affiliates. It also prevents the possible manipulation of transactions between affiliates that may occur with separate accounting. Most states do not allow or do not require combined reporting. Montana is one of 16 states, now including Texas, that require combined unitary reporting.

UDITPA: The Uniform Division of Income for Tax Purposes Act is a model law for apportioning the income of a corporation that is taxable in more than one state. The model law was developed in 1957 to deal with the apportionment of taxable corporate income.

In 1969, Montana adopted the provisions of UDITPA by enacting the Multistate Compact. Article 1 of the compact sets forth the purposes of the law:

(1) facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes;

(2) promote uniformity or compatibility in significant components of tax systems;

(3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration;

(4) avoid duplicative taxation.

The net income of a multistate or multinational corporation doing business in Montana is allocated by a three-factor, simple-average apportionment formula. If, for example, 1/3 of property of a multistate firm is located in Montana, 1/3 of its payroll is paid in Montana, and 1/5 of its sales occur in Montana, about 29% of its net income would be subject to taxation in Montana: (33.3% + 33.3% + 20%)/3 = 28.9%.

One of the shortcomings of apportionment in general is that more than 100% of income may be taxed or that some income may escape taxation.

## Erosion of the Corporate Tax Base

According to William F. Fox and LeAnn Luna, the relative importance of state corporation taxes has declined since the mid-1980s. State corporate taxes measured

[21] *Ibid.*, p. 4.

as a percentage of corporate profits (effective tax rate), taxes as a percentage of total state tax revenue, and taxes as a percentage of gross domestic product have generally declined since 1982-1986. They cite four reasons that have contributed to the decline in the relative importance of state corporation income tax revenue: cyclical declines in profits, reductions in the federal corporation tax base, state policy decisions to reduce corporate tax burdens (including tax concessions, changes to the apportionment formula, and the creation of limited liability companies), and more aggressive corporate tax planning.[22]

One example of state policies affecting the taxation of corporations is the weighting of sales in the apportionment formula. In 1990, 34 states used the 3-factor, simple-average apportionment formula.[23] Now, only 13 states, including Montana, use simple-average apportionment. The rest of the states at least double-weight the sales factor. Oregon, which in 1990 used simple-average apportionment, will use a single sales factor apportionment formula beginning in 2007.

Giving more weight to the sales factor in the apportionment formula is promoted for economic development in order to attract more investment to the state, either by expansion of existing multistate businesses or the location of new multistate businesses in the state. Double-weighting sales increases the tax on some corporations, decreases it on others, and has no effect on corporations that conduct all their business in-state.[24] Giving greater weight to the sales factor may bring a larger share of a multistate corporation's income into the taxing state. On the other hand, giving greater weight to sales usually results in lower taxes for corporations that have a greater proportion of property and payroll in the state than do other corporations.[25] If sales were double-weighted in Montana, the amount of taxable income apportioned to the state in the example above would be 26.6% compared with 28.9%: ((33.3% + 33.3% + 20% + 20%)/4 = 26.6%), or about an 8% reduction.

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[22]Fox, William F. and Luna LeAnn, "State Corporate Tax Revenue Trends: Causes and Possible Solutions", *National Tax Journal* (National Tax Association Symposium: Policy Issues for Taxing Times, Volume LV, No. 3, September 2002, pp. 491-508.

[23]See Table 26 (Corporate Income Tax Details, by State) in *Significant Features of Fiscal Federalism*, Vol. 1 (Washington, D.C.: U.S. Advisory Commission on Intergovernmental Relations, 1991) pp. 76-82.

[24]Pomp, Richard D., "The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer", in The Future of State Taxation, edited by David Brunori (Washington, D.C.: Urban Institute Press, 1998), p. 56.

[25]*Ibid.*, p. 56.

The weighting of apportionment factors does not affect taxes paid by businesses that operate entirely within the state. Some states (e.g., Connecticut, Massachusetts, Missouri, and Rhode Island) allow taxpayers in certain industries to apportion income using a single-sales factor formula.

According to Richard Pomp, the trend to weighting the sales factor more heavily led to a $500 million loss in revenue and probably did not promote economic development.[26] On the other hand, Chris Atkins cites a study by Austan Goolsbee and Edward Maydew that found that reducing the weight of the payroll factor and more heavily weighting the sales factor increases in-state employment. He points out that the study notes that job growth is a zero-sum game if other states follow suit.[27]

### The Eye of the Beholder

Charles McLure makes the following observations in assessing the condition (or as he puts it, the "nuttiness") of state corporation income taxes:

- Not all states provide for combination or unitary businesses [most do not].
- States that do provide for combination do not necessarily define a unitary business the same way.
- Even when states use the same apportionment factors to divide the business income of multistate corporations, they do not all assign the same weights to the various factors.
- The current trend is to place a disproportionate weight on the sales factor in an effort to attract economic activity [uniformity does not necessarily require the simple-average apportionment formula].
- States do not use identical definitions of the apportionment factors, especially sales.
- The existence of substantial sales in a state does not imply taxable nexus, even if the state employs only sales to apportion income.[28]

Other analysts of state tax policy may not agree with these observations about the "nuttiness"of state corporation income taxes, but the observations do indicate some weaknesses may exist in the disparate approaches that the states have taken in the taxation of corporate income.

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[26] *Ibid.*, p. 59.

[27] Atkins, *op. cit.*, p. 7.

[28] McLure, Charles E., Jr., "Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough", *National Tax Journal* (Washington, D.C.: National Tax Association, September 2005) p. 565.

# Chapter Ten
# Perspectives on Business Income Taxation

As part of the Revenue and Transportation Committee's review of business income taxation, Joe Shevlin, a Helena CPA, Mike Green, a Helena tax attorney, and Dan Bucks, director of the Department of Revenue, presented reports on various aspects of business income taxation at the Committee's February 16, 2006, meeting.

## Pass-Through Entities

Shevlin discussed the types of business entities such as regular corporations and the various kinds of pass-through entities, including small business corporations, general partnerships, limited liability companies, limited liability partnerships, and disregarded entities (a business owned by one person). Except for regular corporations, taxes are paid by the owners, shareholders, or partners of the pass-through entity. Liability, type of business, business plan, assets, access to capital, and tax laws are the kinds of factors taken into account when deciding on the business entity type. According to Shevlin, businesses are tending to organize as pass-through entities rather than as regular corporations because of limits on entity liability, more favorable tax treatment, and fewer legal requirements. Shevlin also said that the tax rates for individuals and corporations at both the state and federal level are similar.

## Multistate Corporation

Most business taxes in Montana are paid by multistate (or multinational) corporations. Mike Green highlighted some of the issues, including worldwide combined reporting, the definition of worldwide income, and the apportionment factors (property, sales, and payroll) used to determine the tax liability of a multistate corporation in a particular state, that these corporations deal with in Montana and other states. He raised the question of whether the three factors contribute equally to the production of income. Many states have moved to weighting sales more heavily in the apportionment of income. Green said that the absence of uniformity of corporate taxation nationwide may create a risk of taxing more than a 100 percent of a corporation's taxable income.

## Problems of Reporting Business Income

At the Committee's December 2, 2005, meeting, Committee staff presented a background report on corporation income taxes. During the discussion, Dan Bucks,

director of the Department of Revenue, was asked about the four or five major problems related to business income taxes. Bucks responded more fully to that question at the February meeting. According to Bucks, abusive tax shelters, corporate tax loopholes (real estate investment trusts, insurance stuffing, and transfer pricing), and the use of trusts to hide income reduce the amount of taxes that should be collected in Montana. In addition, unreported income by nonresidents receiving rents or royalties or selling property in the state, by certain companies doing business in the state, and by some pass-through entities is a problem.

At the Committee's September 8, 2006, meeting, Bucks presented a summary of the Department of Revenue's legislative proposals. Several of the proposals deal with what the Department considers abusive tax shelters, loopholes, and other activities that result in tax collections being lower than what they legally should be.[1]

[1] A summary of the Department of Revenue's proposals is contained in Minutes, Revenue and Transportation Committee, September 8, 2006, Exhibit # 24.

# Part Three

## Other Topics Before the Revenue and Transportation Committee

# Chapter Eleven
# Other Topics Before the Revenue and Transportation Committee

During the 2005-06 interim, the Revenue and Transportation Committee considered several topics in addition to the House Joint Resolution No. 44 study of the property taxation of certain oil and natural gas property and the overview of business taxes. This chapter provides a brief summary of some of those topics and Committee action, if any.

## Estimating and Monitoring General Fund Revenue Collections and Gaining Access to Tax Information

Revenue Monitoring

Before each regular legislative session, the Committee is required to estimate the amount of revenue available for legislative appropriation (5-5-227(2), MCA). In the fall preceding a regular session, the Committee estimates, with the assistance of the Legislative Fiscal Division (LFD), the Governor's budget office, and other state agencies, revenue for the state general fund and certain nongeneral fund revenue sources (e.g., motor fuels taxes). These estimates are contained in a house joint resolution that is introduced for legislative consideration. During the interim, the Committee monitors general fund revenue collections.

At the Committee's September 30, 2005, meeting, Terry Johnson, Principal Fiscal Analyst, LFD, presented a report on the preliminary fiscal year 2005 ending fund balance of the state general fund. The general fund ending fund balance was $297 million, or $135 million more than expected by the 2005 Legislature. On the revenue side, collections, led by the individual income tax (about 15% higher) and the corporation license tax (48% higher), were $133.4 million more than estimated in House Joint Resolution No. 2 (HJR 2).[1] On the expenditure side, disbursements were $23.2 million less than budgeted. When that amount is combined with net reversions from the previous year (-$10.9 million), net reversions for fiscal year 2005 were $5.4 more than expected. Higher revenue collections ($133.4 million) and net reversions

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[1] The House of Representatives did not concur in the Senate amendments to HJR 2 and the resolution died "in the process". However 5-5-227(3), MCA, provides that the Revenue and Transportation Committee's estimate, as introduced in the Legislature, constitutes the Legislature's current revenue estimate until amended or until final adoption of the estimate by both houses. In this case, the Senate version of the resolution constituted the Legislature's estimate.

($5.4 million) less a $1.6 million balance adjustment accounted for the higher ending fund balance. Based on preliminary analysis, Johnson told the Committee that the 2007 biennium general fund ending fund balance would be $204.6 million, or $128.6 million higher than projected.

December 2005 Special Session Revenue Estimates

In anticipation of a December 2005 special legislative session to deal with school funding and the unfunded liability in the public employees' retirement system and the teachers' retirement system, the Committee had decided to revise the HJR 2 revenue estimates. Terry Johnson recommended that the Committee consider only those revenue sources that showed the largest increases from the HJR 2 estimates: individual income taxes, corporation license taxes, and oil and natural gas production taxes. Johnson also recommended that the Committee consider the property tax because of its significance in any new public school funding formula.

On December 5, 2005, Governor Brian Schweitzer called a special session of the Legislature beginning December 14. The Committee met on December 13, 2005, to adopt revised revenue estimates. Typically, the LFD and the budget office each present recommendations to the Committee on revenue estimates. However, the differences in estimates were insignificant and were presented to the Committee as "consensus" estimates. Terry Johnson presented the revised assumptions for determining the revenue estimates for the individual income tax, the corporation license tax, the oil and natural gas production tax, and the property tax.

Johnson recommended that the Committee increase the 2007 biennium estimate for individual income taxes by $153.2 million, or 12.4%, above the HJR 2 estimate of $1.24 billion.[2] The higher estimate for individual income taxes was based on wage and salary growth rates above the HJR 2 assumption, the HJR 2 growth rate applied to a higher base of dividend income, the long-term growth rate in capital gains (the HJR 2 assumption was no growth in capital gains), and the HJR 2 growth rate applied to a higher base of rents, royalties, and partnership income.

Johnson recommended that the Committee increase the 2007 biennium estimate for corporation license taxes by $28.6 million, or 17.8%, above the HJR 2 estimate of $160.1 million based primarily on U.S. pretax profits.

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[2]After each regular session, the Legislative Fiscal Division adjusts the HJR 2 estimates to include estimated changes in revenue as a result of legislation enacted during the session.

Johnson recommended that the Committee increase the 2007 biennium estimate for oil and natural gas production taxes by $65.8 million, or 52.2%, above the HJR 2 estimate of $126.2 million. Higher commodity prices for oil and natural gas and somewhat higher oil production account for most of the increase.

After toying briefly with the idea of lowering projected oil prices from $57.79 a barrel in fiscal year 2006 to $50, the Committee voted to adopt the LFD's recommendations. The Committee's action, including a small increase in the estimated revenue from the state's share of property taxes, increased the total 2007 biennium general fund revenue estimate by $253 million. The revised revenue estimates were contained in House Joint Resolution No. 1 (HJR 1).[3]

Taking into account the fiscal year 2005 general fund ending fund balance and estimates of additional revenue, supplemental appropriations, other adjustments, and the governor's special session recommended appropriations, the 2007 biennium general fund ending fund balance was projected to be $234.7 million.

Fiscal Year 2006 General Fund Revenues and Fund Balance

At the Committee's September 8, 2006, meeting, Terry Johnson presented a report on the preliminary fiscal year 2006 ending fund balance of the state general fund. The general fund ending fund balance was $422.9 million[4], or $195.1 million more than expected by the Legislature after the December special session. Revenue collections were $165.6 million more than estimated, led once again by individual income taxes ($91.1 million higher) and corporation license taxes ($62.2 million higher). Oil and natural gas taxes were $6.8 million less than estimated. Because calendar year 2005 wage and salary growth was below the amount assumed in HJR 1, Johnson speculated that the higher individual income tax collections may be attributable to nonwage sources of income, including capital gains from the real estate and equity markets, oil and gas royalty payments, employee incentives, and dividends. An increase in corporate profits since 9/11, particularly in the energy and financial sectors, accounts for a large part of the higher collections. In addition, a delay in "unusual" corporation refunds and higher audit collections also contributed to

[3]On December 15, 2005, the House Appropriations Committee, on a tie vote, sent HJR 1 on without recommendation. That was the last that was heard of the ill-fated resolution.

[4]This amount is overstated because a transfer of $15.7 million to the police and firefighters retirement fund did not occur in fiscal year 2006 as it should have.

higher revenues. Reversions of $33.5 million accounted for about 17% of the higher fund balance.

Johnson said that the 2007 biennium general fund ending fund balance could be as high as $525 million based on additional revenue collections of $317.8 million, wildfire and supplemental appropriations of $72.6 million, net reversions of $32.3 million, fiscal year 2006 fund balance adjustments, and the transfer of $15.7 million to the police and firefighters retirement fund.

The determination of the 2007 biennium fund balance is based on limited information about trends in individual income tax and corporation license tax collections and also on budgeted disbursements and estimated wildfire costs and supplemental appropriations. It is unclear at this time what portion of higher revenue collections are one-time or of short-term duration and what portion are long-term. Wildfire costs and supplemental appropriations could be higher than expected. In addition, federal legislation could affect both revenues and expenditures during the next biennium. After the Revenue and Transportation Committee adopts the initial revenue estimates for the 2009 biennium, the Legislature may have a better idea of what to expect during the next session.

Committee Recommends Formalizing Revenue Estimating for Special Sessions

Before the 1989 legislative session, there was no formalized statutory process for the Legislature to estimate state revenue. During that session, the Legislature passed legislation (Ch. 608, L. 1989) directing the then-Revenue Oversight Committee to develop revenue estimates and introduce a resolution "in each regular session and each special session in which a revenue bill is under consideration." In a move without any recorded reason, the Legislature during the 1991 legislative session removed the provision that the Revenue Oversight Committee develop revenue estimates for a special session in which a revenue bill is considered (Ch. 603, L. 1991). However, the former Revenue Oversight Committee and the Revenue and Transportation Committee have introduced a revenue estimating resolution for legislative consideration during special sessions.

At its June 30, 2006, meeting, the Revenue and Transportation Committee approved a bill draft that would allow the Committee to prepare for introduction during a special session of the Legislature in which a revenue bill or an appropriation bill is under consideration an estimate of the amount of projected revenue. Under the proposal,

the revenue estimating resolution would be considered part of the call of a special session. The bill draft (LC0195) will be introduced by request of the Committee.

Access to Tax and Revenue Information

Both the Revenue and Transportation Committee and the Legislative Finance Committee requested that the Department of Revenue work with the Legislative Fiscal Division to develop procedures to ensure that the LFD has timely access to relevant tax information for preparing revenue estimates.

At the December 2, 2005, Committee meeting, members raised the concern that the Legislative Fiscal Division staff were not getting tax and revenue information from the Department in a timely manner, either for developing revenue estimates or for policy analysis.

In particular, the Committee discussed whether the LFD should have access to identifying information (e.g, name, social security number, and federal identification number) on individual income taxpayers. Having that type of information would allow staff to provide more detailed analysis for the Legislature. Under current Montana law, all identifying information on individual income tax returns is stripped before returns are provided to the LFD and the Governor's budget office. In addition, Internal Revenue Service rules limit how federal income tax return information is exchanged. The Committee also discussed the level of identifying information on corporation income taxpayers, confidentiality provision, the process by which information is requested and provided, the establishment of an audit procedure for the exchange of information, and access to the Department's software applications.

The Committee directed the Legislative Fiscal Division and the Department of Revenue to put into effect a memorandum of understanding to facilitate the exchange of tax and revenue information between the Department and the LFD.

At the Committee's May 2, 2006, meeting, the LFD and the Department of Revenue reported on the memorandum of understanding signed by both agencies. The memorandum provides for the information subject to exchange, confidentiality of the information, procedures for exchange of information, including access to Department software applications, and the destruction of exchanged information. The agreement is in place for 6 years and may be revised to incorporate changes in state law or by revisions agreed to by both parties.

At the May 2 meeting, the Committee also considered a bill draft that would revise and clarify the laws on agency access to tax information (LC0043).[5] The bill would allow the LFD and the budget office access to identifying individual income tax information and would clarify that these agencies would have access to identifying corporation license tax information. The director of the Department of Revenue said he had concerns about providing identifying information for individual income tax returns. At its September 8, 2006, meeting, the Committee reconsidered the bill draft, including a change proposed by the Department. Under that proposed change, the Department would strip identifying individual income tax information and create an accounting number for each taxpayer that would allow the LFD to annually track an individual's tax return without knowing who the taxpayer is. The Committee did not act on either version but will take up the topic again at its November 15, 2006, meeting.

## Rule Review

Section 5-5-215, MCA, requires legislative interim committees to review administrative rules within their jurisdiction. There were two rules proposed by the Department of Revenue that caught the Revenue and Transportation Committee's attention.

Taxation of 1031 exchanges

In 2001, the Montana Legislature enacted House Bill No. 143 (Ch. 143, L. 2001) to change the reporting of pass-through entity income. The legislation also included a definition of Montana source income for individual income tax purposes.[6] Late last year, the Department of Revenue proposed a rule to clarify that Montana source income includes, among other things, the gain on a 1031 like-kind exchange when the gain is recognized in a taxable transaction. Gains on like-kind exchanges, which may involve many transactions, are deferred until recognized for federal income tax purposes.

Some people questioned whether the Legislature intended to include the gain from like-kind exchanges as Montana source income or whether the Department could

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[5] The Committee requested the bill draft at its February 16 meeting.

[6] The definition of Montana source income includes, among other items, gain attributable to the sale or other transfer of tangible property located in the state, sold or otherwise transferred while a resident of the state, or used or held in connection with a trade, business, or occupation carried on in the state. See 15-30-101, MCA.

reasonably administer the rule. At its December 13, 2005, meeting, the Committee considered a motion to require the Department to prepare an economic impact statement, as provided in 2-4-405, MCA, on the proposed change; the motion failed on a 6-6 vote. During the December special session, enough petition signatures were obtained from legislators to require the Department to prepare the economic impact statement.

The Committee reviewed the economic impact statement at its February 16, 2006, meeting.[7] Two national tax experts, Walter Hellerstein, a professor at the University of Georgia law school, and Vern Hoven, a Washington state CPA, supported the Department's position on the rule. Lee Heiman, staff attorney, said the economic impact statement complied with state law. The Committee took no action on the statement.

Heiman also reviewed the Department's proposed rule on how to determine the taxable gain on the final disposition of 1031 property and the proposed rule to waive penalties and one-half of the interest on gains realized in prior tax years but not reported for tax purposes. The rules are available on the Department of Revenue's website.

Taxation of Little Cigars

During the public comment period at the Committee's June 29, 2006, meeting, Drs. Richard Sargent and Robert Shepard discussed the sale and taxation of "little cigars" in Montana. Sargent and Shepard said that certain little cigars are really cigarettes and should be packaged and taxed as cigarettes. Dan Bucks, director of the Department of Revenue, told the Committee that the Department had the authority to revise its rules related to the definition of cigarettes.

On August 31, 2006, the Department held a public hearing to consider, among other things, the determination of whether a tobacco product is cigarette within the meaning of 16-11-102, MCA. A new rule (New Rule II) established criteria by which the Department would determine whether a tobacco product labeled as anything other than a cigarette is a cigarette. The product would be considered a cigarette if it met two or more of the seven criteria.

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[7] Minutes, Revenue and Transportation Committee, February 16 and 17, pp. 14-19.

At the Committee's September 8, 2006, meeting, the Committee reviewed the proposed rules. Kelly O'Sullivan, Assistant Attorney General, Montana Department of Justice, summarized a petition filed by 40 state attorneys general with the U.S. Treasury's Alcohol and Tobacco Tax and Trade Bureau requesting that the Bureau revise its rules on the classification of little cigars.[8] Current federal rules allow a manufacturer to designate whether a tobacco product is a cigar or a cigarette. Cigars are not subject to the same public health restrictions or taxes that are on cigarettes.

In the 2005 legislative session, the Legislature passed and the Governor signed House Bill No. 687 (HB 687) (Ch. 511) to revise the tobacco products laws. The legislation revised the definitions related to tobacco products under 16-11-102, MCA. At the September 8, 2006, meeting, Lee Heiman told the Committee that the Department of Revenue had the authority to adopt the new rules to determine what tobacco products fall within the expanded definition of cigarettes contained in HB 687.[9]

Several persons spoke in favor the proposed rules. However, Mark Staples, Montana Tavern Association, said the purpose of HB 687 was to deal with smuggling cigarettes, illegal Internet sales, and other enforcement issues. Staples said the issue should be considered by the Legislature and not through rulemaking. Ronna Alexander, Convenience Store Association, also said that reclassifying certain tobacco products as cigarettes should be determined by the Legislature.

The Committee discussed whether the issue should be resolved by administrative rule or by the Legislature. Representative Bob Lake moved to send a letter to the Department stating that the Committee recognizes the Department's authority to propose the rules but, in light of the complexity of the rules, that the Department delay implementing the rules until the Legislature convenes in January. The motion failed on a 5-7 vote.

## Transportation Topics

Highway 2

At the Committee's May 2, 2006, meeting, Senator Sam Kitzenberg, Revenue and Transportation Committee member, and Bob Sivertsen, President of the Highway 2

[8] The petition is available at http://www.naag.org/news/pr-20060519-little-cigars.php.

[9] See Minutes, Revenue and Transportation Committee, September 8, 2006, Exhibit #9.

Association, discussed the importance of an improved transportation system to economic development in northern Montana. A four-lane highway along the Highway 2 corridor would help revitalize the economy in the area. An improved highway would be safer for the traveling public and promote agriculture, the oil and gas industry, electrical energy development, and tourism. An expanded highway would also help economic development in the four Indian reservations along the corridor. According to Kitzenberg and Sivertsen, the new corridor would benefit the entire state.

Highway Safety

At the committee's February 16, 2006, meeting, Jim Lynch, director of the Montana Department of Transportation, took some of us back to our driver's education days in high school by showing a public service announcement depicting what happens to unbuckled passengers in an automobile crash. While not as grisly as the film we saw in driver's education, the message was a grim reminder of the importance of wearing seat belts. The announcement, produced in New Zealand, was part of a traffic safety report that included statistics on the economic loss in Montana associated with traffic accidents, seat belt use, and alcohol-related fatalities. According to Lynch, the economic loss (e.g., wage and productivity losses, medical expenses, and administrative costs) in Montana because of vehicle crashes was $806 million in 2004, up 68 percent from 1995. Of the economic loss in 2004, $170 million was attributable to crashes in which alcohol was involved. Statistics compiled by the National Highway Traffic Safety Administration indicate that Montana has the highest alcohol-related fatality rate in the nation. On a positive note, the percentage of alcohol-related traffic deaths in Montana declined over the last several months of 2005. Lynch said that although it was too early to tell whether the new open container law has had an effect, he was encouraged by the trend.

Lynch's presentation sparked a variety of questions about traffic safety, including road conditions, and renewed the Committee's interest in having regular traffic safety updates.

At the same meeting, Jim Lynch reported on certain aspects of highway safety. For the period 2001 through 2005, the largest number of fatalities occurred in single vehicle crashes. Lynch pointed out that about 50 percent of all fatalities involve the use of alcohol. Almost 750 fatalities during that period occurred on U.S. highways and state roads. Fatalities on the interstate and county roads numbered a little over 200 each. Lynch also reported on nonscientific and on engineering speeding studies

on several highways in the state, traffic enforcement activity on U.S. 191 between Four Corners and Big Sky, and the number of open container violations by county between October 1, 2005, and May 1, 2006.

Federal Reauthorization of Transportation Funding

Federal funding provides significant revenue for states for highway construction, highway safety, improving other transportation systems, public transportation, and earmarked projects. The previous federal funding legislation, the Transportation Equity Act for the 21st Century, expired September 30, 2003. Since then, the President had signed seven extensions that provided temporary transportation funding to the states. For about 2 years, Congress squabbled over appropriate funding levels for the states. In late July 2005, Congress finally approved a federal funding reauthorization measure for highway construction and other transportation-related projects. On August 10, 2005, President George Bush signed into law the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (dubbed SAFETEA-LU).

At the Committee's September 30, 2005, meeting, Jim Lynch, director of the Montana Department of Transportation, said the new federal funding formula authorized $2.3 billion for Montana in 2009, representing a 44% over TEA-21. Although the formula provides annual increases in funding, Montana will receive an average of $355 million through 2009. The state will also receive $216 million for specific projects, including a feasibility study for a four-lane highway from Glasgow to the North Dakota border. At a previous meeting, Jim Lynch said that the Department of Transportation would not have to request an increase in motor fuels taxes to match federal funding.

State-Tribal Gas Tax Agreements

Title 18, chapter 11, MCA, allows state and local governments to enter into cooperative agreements, including tax revenue sharing agreements, with tribal governments. The purpose of revenue sharing agreements is to prevent dual taxation of the same activity.

Section 15-70-234, MCA, requires that the Department of Transportation present gasoline tax revenue sharing agreements to the Revenue and Transportation Committee for review and comment before the agreement is given to the Attorney General for final approval. The state renegotiated an existing gasoline tax revenue sharing agreement with the Blackfeet Tribe. The new agreement runs through June

30, 2015, and revises the distribution of gas tax revenue to the tribe based on prior fiscal year taxes collected per capita. The new formula results in a little over $21,000 increase in revenue for the Blackfeet Tribe this year. At the Committee's September 30, 2005, meeting, Jim Lynch, director of the Department, summarized the provisions of the agreement.

The state also renegotiated an existing gasoline tax revenue sharing agreement with the Rocky Boy Indian Reservation. The new agreement runs through December 2016 and changes the method for determining the number of enrolled tribal members on the reservation and revises the formula for distributing the reservation's share of gas tax revenue. The allocation of revenue to the Rocky Boy Indian Reservation is virtually identical to the existing agreement, and the agreement does not affect taxes paid by consumers. At the Committee's December 16, 2005, meeting, Jim Lynch summarized the provisions of the agreement.

# Appendix A

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**Revenue and Transportation Interim Committee**

**59th Montana Legislature**

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**COMMITTEE STAFF**
JEFF MARTIN, Lead Staff
LEE HEIMAN, Staff Attorney
DAWN FIELD, Secretary

December 2, 2005

TO: Revenue and Transportation Interim Committee

FROM: Lee Heiman, Staff Attorney

RE: Central assessment and classification of property

Most property is classified for tax purposes by type and use. Some property, however, is classified by how it is assessed. Three classes of property use the property's centrally assessed status factor in its classification. The sections are:

**15-6-141. Class nine property -- description -- taxable percentage.** (1) Class nine property includes:

(a) centrally assessed allocations of an electric power company or centrally assessed allocations of an electric power company that owns or operates transmission or distribution facilities or both, . . .

(b) allocations for centrally assessed natural gas companies having a major distribution system in this state; and

(c) centrally assessed companies' allocations except:

(i) electrical generation facilities classified under 15-6-156 and wind generation facilities classified under 15-6-157;

(ii) property owned by cooperative rural electric and cooperative rural telephone associations and classified under 15-6-135;

(iii) property owned by organizations providing telephone communications to rural areas and classified under 15-6-135;

(iv) railroad transportation property included in 15-6-145;

(v) airline transportation property included in 15-6-145; and

(vi) telecommunications property included in 15-6-156.

(2) Class nine property is taxed at 12% of market value.

**15-6-156. Class thirteen property -- description -- taxable percentage.** (1) Except as provided in subsections (2)(a) through (2)(g), class thirteen property includes:

(a) electrical generation facilities, except wind generation facilities classified under 15-6-157, of a centrally assessed electric power company;

. . .

(c) noncentrally assessed electrical generation facilities, except wind generation facilities classified under 15-6-157, owned or operated by any electrical energy producer; and

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(d) allocations of centrally assessed telecommunications services companies.

. . .

(4) Class thirteen property is taxed at 6% of its market value.

**15-6-157. Class fourteen property -- description -- taxable percentage.** (1) Class fourteen property includes:

(a) wind generation facilities of a centrally assessed electric power company;

. . .

(c) noncentrally assessed wind generation facilities owned or operated by any electrical energy producer;

. . .

(4) Class fourteen property is taxed at 3% of its market value.

The centrally assessed property is:

**15-23-101. Properties centrally assessed.** The department shall centrally assess each year:

(1) the railroad transportation property of railroads and railroad car companies operating in more than one county in the state or more than one state;

(2) property owned by a corporation or other person operating a single and continuous property operated in more than one county or more than one state, including but not limited to telegraph, telephone, microwave, and electric power or transmission lines; natural gas or oil pipelines; canals, ditches, flumes, or like properties and including, if congress passes legislation that allows the state to tax property owned by an agency created by congress to transmit or distribute electrical energy, property constructed, owned, or operated by a public agency created by congress to transmit or distribute electrical energy produced at privately owned generating facilities, not including rural electric cooperatives;

(3) all property of scheduled airlines;

(4) the net proceeds of mines, except bentonite mines;

(5) the gross proceeds of coal mines; and

(6) property described in subsections (1) and (2) that is subject to the provisions of Title 15, chapter 24, part 12.

The use of central assessment to classify property was enacted by Chapter 686, Laws of 1979. Its purpose was to establish a workable central assessment system. Before its amendment, 15-23-101, MCA, provided for central assessment of single and continuous property, but "buildings on right-of-way, land outside the right-of-way and improvements thereon, dams and powerhouses, furniture, machinery, and other personal property situated within a county shall be assessed in that county". Prior to the enactment of Chapter 686, property was in a class that provided "centrally assessed utility allocations after deductions of locally assessed properties, except" rural telephone and cooperatives, and that taxed the property at 16% of market value. Chapter 686 established a new class, class nine, which we still have as 15-6-141, MCA. As enacted, the class had two rates: 12% for electric power and natural gas companies' centrally assessed allocations and 15% for general centrally assessed allocations not otherwise exempted. The 15% provision was deleted in 1985. The net effect of Chapter

686 was to eliminate the deduction of locally assessed operating property from the central assessment and move the utility centrally assessed property into a new class with a rate of 12% rather than 16%. The committee minutes reflect that the utilities actually paid somewhat more property taxes because the deduction of locally assessed property disproportionally reduced unit values of centrally assessed property. The change did, however, provide for a more stable tax base and a more equitable allocation formula for counties.

Because of deregulation of utilities, I think it would be useful to review whether central assessment should be a factor in the classification of property. It might be more logical to remove the descriptive language in the central assessment section and move it to the classification sections. The central assessment section could then provide that operating properties in certain classes, if under single ownership that crosses a county or state boundary, should be assessed centrally with the value allocated to the respective jurisdictions by the state. Central assessment of multicounty operating property without requiring continuous property going over a county or state boundary, as is done for airlines under 15-23-101(3) and Title 15, chapter 23, part 4, MCA, might also be explored.

# Appendix B

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**Revenue and Transportation Interim Committee**

**59th Montana Legislature**

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JEFF MARTIN, Lead Staff
LEE HEIMAN, Staff Attorney
DAWN FIELD, Secretary

December 2, 2005

TO: Revenue and Transportation Committee

FROM: Lee Heiman, Staff Attorney

RE: Invalidation of Part of Central Assessment Rule

On August 9, 2005, a partial summary judgment was granted that invalidated a part of an administrative rule governing central assessment of property. District Court Judge Jeffrey M. Sherlock ruling in Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County) determined that ARM. 42.22.103(3) was invalid.

A validly adopted administrative rule has the same legal effect as a statute. To be valid, the adoption must comply with the Montana Administrative Procedure Act, found in Title 2, chapter 4, MCA. Section 2-4-305(6)(a), MCA, requires that a rule be "consistent and not in conflict with the statute" that is being implemented. The statute that was implemented by ARM. 42.22.103(3) is 15-23-101, MCA:

> **15-23-101. Properties centrally assessed.** The department shall centrally assess each year:
>
> (1) the railroad transportation property of railroads and railroad car companies operating in more than one county in the state or more than one state;
>
> (2) property owned by a corporation or other person operating a single and continuous property operated in more than one county or more than one state, including but not limited to telegraph, telephone, microwave, and electric power or transmission lines; natural gas or oil pipelines; canals, ditches, flumes, or like properties and including, if congress passes legislation that allows the state to tax property owned by an agency created by congress to transmit or distribute electrical energy, property constructed, owned, or operated by a public agency created by congress to transmit or distribute electrical energy produced at privately owned generating facilities, not including rural electric cooperatives;
>
> (3) all property of scheduled airlines;
>
> (4) the net proceeds of mines, except bentonite mines;
>
> (5) the gross proceeds of coal mines; and

(6) property described in subsections (1) and (2) that is subject to the provisions of Title 15, chapter 24, part 12. *(emphasis added)*

ARM 42.22.103 reads:

> 42.22.102 CENTRALLY ASSESSED PROPERTY (1) The department shall centrally assess the interstate and inter-county continuous properties of the following types of companies:
>
> (a) railroad;
> (b) railroad car;
> (c) microwave;
> (d) telecommunications;
> (e) telephone cooperatives;
> (f) gas;
> (g) electric;
> (h) electric cooperatives;
> (i) ditch;
> (j) canal;
> (k) flume;
> (l) natural gas pipeline;
> (m) oil pipeline; and
> (n) airline.
>
> (2) The property of a centrally assessed company is separated into two categories: operating and non-operating. All operating property will be apportioned to the taxing units as provided in ARM 42.22.121 and 42.22.122.
>
> (3) The department will determine centrally assessed property based on the property's operating characteristics such as but not limited to property use, integration of operations, management, and corporate structure. *(emphasis added)*

In the order, Judge Sherlock cited Safeway, Inc. v. Montana Petroleum Release Comp. Bd., 281 M 189, for the proposition that administrative rules are "out of harmony" and void with legislative guidelines if they "(1) engraft additional and contradictory requirements on the statute; or (2) if they engraft additional, noncontradictory requirements on the statute which were not envisioned by the legislature". Judge Sherlock then wrote:

> Despite DOR's contention, however, it does appear that the administrative rule has impermissibly expanded the statute. The statute specifically states that centrally assessed property consists of "single and continuous property operated in more than one county or more than one state," while the administrative rule includes in the definition property that is not single and continuous. The agency was not granted the authority in the statutes to include additional types of property to be centrally assessed.

On October 27, 2003, District Court Judge Marc G. Buyske, in an order that was brought to Judge Sherlock's attention, ruled in a partial summary judgment in Pancanadian Energy Resouces v. Department of Revenue, (No. DV-02-3223, Twelfth Judicial District, Liberty County) that ARM 42.22.102(3) was valid. Judge Buyske wrote: "The statute [15-23-101(2), MCA] which the rule explicates provides centrally assessed 'property' includes 'but [is] not limited to' a list of property types." He then discussed property not listed in the statute and its ownership. He held that the scope of the rule did not impermissibly expand the statute but reasonably explained what factors will be used to determine property not specifically enumerated in the statute but subject to central assessment.

The invalidity granted by Judge Sherlock raises factual questions on the scope of central assessment by the Department.

A hearing was set for December 12; however, the taxpayer filed a motion to vacate the hearing on the premise that there are summary judgment motions outstanding. The Court granted the taxpayer's motion. The hearing was rescheduled for the middle of September 2006.

# Appendix C

**** Bill No. ****

Introduced By *************

By Request of the *********

A Bill for and Act entitled: "An Act providing that a legal entity that is primarily an oil or gas producer is not centrally assessed; providing a declining 3-year reimbursement for property tax loss to local governments that is statutorily appropriated; amending sections 15-23-101 and 17-7-502, MCA; providing an immediate effective date; and providing a retroactive applicability date."

Be it enacted by the Legislature of the State of Montana:

**Section 1.** Section 15-23-101, MCA, is amended to read:

**"15-23-101. Properties centrally assessed.** (1) ~~The~~ Except as provided in subsection (2), the department shall centrally assess each year:

~~(1)~~(a) the railroad transportation property of railroads and railroad car companies operating in more than one county in the state or more than one state;

~~(2)~~(b) property owned by a corporation or other person operating a single and continuous property operated in more than one county or more than one state, including but not limited to telegraph, telephone, microwave, and electric power or transmission lines; natural gas or oil pipelines; canals, ditches, flumes, or like properties and including, if congress

passes legislation that allows the state to tax property owned by an agency created by congress to transmit or distribute electrical energy, property constructed, owned, or operated by a public agency created by congress to transmit or distribute electrical energy produced at privately owned generating facilities, not including rural electric cooperatives;

~~(3)~~(c) all property of scheduled airlines;

~~(4)~~(d) the net proceeds of mines, except bentonite mines;

~~(5)~~(e) the gross proceeds of coal mines; and

~~(6)~~(f) property described in subsections (1)(a) and ~~(2)~~ (1)(b) that is subject to the provisions of Title 15, chapter 24, part 12.

(2) (a) The department may not centrally assess legal entities that are primarily oil or gas producers even if their production facilities include flow lines, gathering lines, or injection lines that cross a county or state line.

(b) For the purposes of this chapter:

(i) "Flow lines" or "gathering lines" are facilities used to move oil or gas from the wellhead to:

(A) an interconnection with either an intrastate or interstate transmission pipeline; or

(B) an interconnection with either a local distribution company or storage facility; and

(ii) "Injection lines" are any facility used by the producer to inject water, air, or other substances into the ground for the purposes of producing oil."

{*Internal References to 15-23-101:*
*15-1-402 a!* *15-1-402a!* *15-1-402a!* *15-1-402a!*
*15-1-402a!* *15-23-105 x* *15-23-807* x*}

NEW SECTION. **Section 2. Reimbursement payment.** (1) The department shall determine the amount of property tax revenue lost by each local government as a result of the amendments to 15-23-101 contained in [section 1]. The department shall use calendar year 2006 as its base year for each determination.

(2) (a) The department shall determine the amount of revenue due each local government for calendar year 2006 from the taxation of legal entities that produce oil or gas as 15-23-101 read for tax year 2006.

(b) The department shall then calculate for each local government for calendar year 2006 the amount of revenue that would have been due from property taxes if [section 1] had been in effect for calendar year 2006.

(3) (a) For the calendar year ending December 31, 2007, the amount of reimbursement is equal to the difference between the amounts calculated under subsection (2).

(b) For the calendar year ending December 31, 2008, the reimbursement is two-thirds the amount calculated in subsection (2).

(c) For the calendar year ending December 31, 2009, the reimbursement is one-third the amount calculated in subsection (2).

(4) The department shall distribute one-half of the reimbursement payment to county treasurers on November 30 of the calendar year for which it is calculated and the remaining one-half on May 31 of the following calendar year. Upon receipt of payment from the department, the county treasurer shall distribute the reimbursement to each local government

based upon the relative proportions of the local government's 2006 mill levy to the total county 2006 mill levies.

(5) As used in this section, "local government" means jurisdiction levying property taxes against personal property and includes a county, consolidated local government, incorporated city, incorporated town, or school district but does not include county or state school equalization levies provided for in 15-10-107, 20-9-331, 20-9-333, 20-9-360, 20-25-423, and 20-25-439.

(6) The local government reimbursements calculated in this section are statutorily appropriated, as provided in 17-7-502, from the general fund to the department for distribution to local governments. .

**Section 3.** Section 17-7-502, MCA, is amended to read:

**"17-7-502. Statutory appropriations -- definition -- requisites for validity.** (1) A statutory appropriation is an appropriation made by permanent law that authorizes spending by a state agency without the need for a biennial legislative appropriation or budget amendment.

(2) Except as provided in subsection (4), to be effective, a statutory appropriation must comply with both of the following provisions:

(a) The law containing the statutory authority must be listed in subsection (3).

(b) The law or portion of the law making a statutory appropriation must specifically state that a statutory appropriation is made as provided in this section.

(3) The following laws are the only laws containing statutory appropriations: 2-15-151; 2-17-105; 5-11-407; 5-13-403; 10-2-603; 10-3-203; 10-3-310; 10-3-312; 10-3-314; 10-4-301; [section 2], 15-1-111; 15-1-113; 15-1-121; 15-23-706; 15-31-906; 15-35-108; 15-36-332; 15-37-117; 15-38-202; 15-65-121; 15-70-101; 15-70-369; 15-70-601; 16-11-509; 17-3-106; 17-3-212; 17-3-222; 17-3-241; 17-6-101; 17-7-304; 18-11-112; 19-3-319; 19-6-404; 19-6-410; 19-9-702; 19-13-604; 19-17-301; 19-18-512; 19-19-305; 19-19-506; 19-20-604; 20-8-107; 20-9-534; 20-9-622; 20-26-1503; 22-3-1004; 23-4-105; 23-4-202; 23-4-204; 23-4-302; 23-4-304; 23-5-306; 23-5-409; 23-5-612; 23-7-301; 23-7-402; 37-43-204; 37-51-501; 39-71-503; 41-5-2011; 42-2-105; 44-1-504; 44-12-206; 44-13-102; 50-4-623; 53-1-109; 53-6-703; 53-24-108; 53-24-206; 60-11-115; 61-3-415; 69-3-870; 75-1-1101; 75-5-1108; 75-6-214; 75-11-313; 77-2-362; 80-2-222; 80-4-416; 80-5-510; 80-11-518; 82-11-161; 87-1-513; 90-1-115; 90-1-205; 90-3-1003; and 90-9-306.

(4) There is a statutory appropriation to pay the principal, interest, premiums, and costs of issuing, paying, and securing all bonds, notes, or other obligations, as due, that have been authorized and issued pursuant to the laws of Montana. Agencies that have entered into agreements authorized by the laws of Montana to pay the state treasurer, for deposit in accordance with 17-2-101 through 17-2-107, as determined by the state treasurer, an amount sufficient to pay the principal and interest as due on the bonds or notes have statutory appropriation authority for the payments. (In subsection (3): pursuant to Ch. 422, L. 1997, the inclusion of 15-1-111 terminates on July 1, 2008, which is the date that section is

repealed; pursuant to sec. 10, Ch. 360, L. 1999, the inclusion of 19-20-604 terminates when the amortization period for the teachers' retirement system's unfunded liability is 10 years or less; pursuant to sec. 4, Ch. 497, L. 1999, the inclusion of 15-38-202 terminates July 1, 2014; pursuant to sec. 10(2), Ch. 10, Sp. L. May 2000, and secs. 3 and 6, Ch. 481, L. 2003, the inclusion of 15-35-108 terminates June 30, 2010; pursuant to sec. 13(1), Ch. 223, L. 2005, the inclusion of 2-15-151 terminates December 31, 2006, and the inclusion of 90-1-115 becomes effective December 31, 2006; pursuant to sec. 7, Ch. 314, L. 2005, the inclusion of 23-4-105, 23-4-202, 23-4-204, 23-4-302, and 23-4-304 becomes effective July 1, 2007; and pursuant to sec. 17, Ch. 593, L. 2005, the inclusion of 15-31-906 terminates January 1, 2010.)"

{*Internal References to 17-7-502:*

| | | | |
|---|---|---|---|
| *2-15-151* | *2-17-105* | *5-11-407* | *5-13-403* |
| *10-2-603* | *10-3-203* | *10-3-310* | *10-3-312* |
| *10-3-312* | *10-3-314* | *10-4-301* | *15-1-111* |
| *15-1-113* | *15-1-121* | *15-23-706* | *15-31-906* |
| *15-35-108* | *15-36-332* | *15-37-117* | *15-38-202* |
| *15-38-202* | *15-65-121* | *15-65-121* | *15-70-101* |
| *15-70-369* | *15-70-601* | *16-11-509* | *17-1-508* |
| *17-3-106* | *17-3-212* | *17-3-222* | *17-3-241* |
| *17-6-101* | *17-7-304* | *17-7-501* | *18-11-112* |
| *19-3-319* | *19-6-404* | *19-6-410* | *19-9-702* |
| *19-13-604* | *19-17-301* | *19-18-512* | *19-19-305* |
| *19-19-506* | *19-20-604* | *20-8-107* | *20-9-534* |
| *20-9-622* | *20-26-1503* | *22-3-1004* | *23-4-105* |
| *23-4-202* | *23-4-204* | *23-4-302* | *23-4-304* |
| *23-5-306* | *23-5-409* | *23-5-612* | *23-7-301* |
| *23-7-402* | *37-43-204* | *37-51-501* | *39-71-503* |
| *41-5-2011* | *42-2-105* | *44-1-504* | *44-12-206* |
| *44-13-102* | *50-4-623* | *53-1-109* | *53-6-703* |
| *53-24-108* | *53-24-108* | *53-24-206* | *60-11-115* |
| *61-3-415* | *69-3-870* | *75-1-1101* | *75-5-1108* |
| *75-6-214* | *75-10-622* | *75-11-313* | *77-2-362* |
| *80-2-222* | *80-4-416* | *80-5-510* | *80-11-518* |
| *82-11-161* | *87-1-513* | *90-1-115* | *90-1-115* |
| *90-1-205* | *90-3-1003* | *90-9-306* } | |

NEW SECTION. **Section 4. {standard} Codification instruction.** [Section 2] is intended to be codified as an

integral part of Title 7, chapter 1, and the provisions of Title 7, chapter 1, apply to [section 2].

NEW SECTION. **Section 5. {standard} Effective date.** [This act] is effective on passage and approval.

NEW SECTION. **Section 6. {standard} Retroactive applicability.** [This act] applies retroactively, within the meaning of 1-2-109, to tax years beginning after December 31, 2006.

- END -

{Drafted by: John Alke, added to by Lee Heiman}