



Revenue and Transportation Interim Committee

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59th Montana Legislature

SENATE MEMBERS

JIM ELLIOTT--Chair
GREGORY BARKUS
JERRY BLACK
KIM GILLAN
SAM KITZENBERG
KEN TOOLE

HOUSE MEMBERS

KARL WAITSCHIES--Vice Chair
JILL COHENOUR
CYNTHIA HINER
BOB LAKE
DAVE MCALPIN
PENNY MORGAN

COMMITTEE STAFF

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

MINUTES

February 16 & 17, 2006

Room 137, State Capitol
Helena, Montana

Please note: These are summary minutes. Testimony and discussion are paraphrased and condensed. Committee tapes are on file in the offices of the Legislative Services Division.

Exhibits for this meeting are available upon request. Legislative Council policy requires a charge of 15 cents a page for copies of the document. Exhibits are also available on the electronic copy of the minutes.

Please note: These minutes provide abbreviated information about committee discussion, public testimony, action taken, and other activities. The minutes are accompanied by an audio recording. For each action listed, the minutes indicate the approximate amount of time in hours, minutes, and seconds that has elapsed since the start of the meeting. This time may be used to locate the activity on the audio recording.

An electronic copy of these minutes and the audio recording may be accessed from the Legislative Branch home page at <http://leg.Montana.gov>. On the left-side column of the home page, select *Committees*, then *Interim*, and then the appropriate committee.

To view the minutes, locate the meeting date and click on minutes. To hear the audio recording, click on the Real Player icon. Note: You must have Real Player to listen to the audio recording.

COMMITTEE MEMBERS PRESENT

SEN. JIM ELLIOTT, Chair

SEN. JERRY BLACK
SEN. SAM KITZENBERG
SEN. KEN TOOLE

REP. JILL COHENOUR
REP. CYNTHIA HINER
REP. BOB LAKE
REP. DAVE MCALPIN
REP. PENNY MORGAN

COMMITTEE MEMBERS EXCUSED

SEN. GREGORY BARKUS
SEN. KIM GILLAN
REP. KARL WAITSCHIES

STAFF PRESENT

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

AGENDA & VISITORS' LIST

Agenda, [Attachment #1](#).
Visitors' list, [Attachment #2](#).

COMMITTEE ACTION

The Revenue and Transportation Interim Committee:

- approved the December 2, 13, and 16, 2005, minutes as written; and
- requested bill draft to revise and clarify laws related to access to tax information.

DAY ONE - PART ONE

CALL TO ORDER AND ROLL CALL

00:00:01 SEN. ELLIOTT called the meeting to order at 9:03 a.m. The secretary took the roll, SEN. BARKUS, SEN. GILLAN, and REP. WAITSCHIES were excused, all other members were present. The Committee approved the minutes, as written, of the December 2, 13, and 16, 2005, meetings by a unanimous voice vote.

MONTANA DEPARTMENT OF HIGHWAYS

00:02:43 **Jim Lynch, Director, Montana Department of Transportation (MDT)**, presented information on highway safety data:

- traffic safety data fact sheet ([EXHIBIT #1](#)):
 - ▶ economic loss in crashes,
 - ▶ crashes on Montana roadways,
 - ▶ crash rate on Montana roadways
 - ▶ seat belt usage on Montana roadways,
 - ▶ seat belt usage for occupant fatalities,
 - ▶ benefits of a primary seat belt law,
 - ▶ alcohol information
 - ▶ American Indian traffic fatalities,
 - ▶ alcohol related fatal crashes by age of driver and open container statistics,
 - ▶ speed information,
 - ▶ speeding versus alcohol involvement in fatal crashes,
 - ▶ corridor speed study of US 191 - Gallatin Canyon;
- contributing circumstances in crashes for 2004 ([EXHIBIT #2](#));
- primary seat belt law fact sheet ([EXHIBIT #3](#));
- Native American Focus Projects for 2006 ([EXHIBIT #4](#));
- US 191 - Gallatin Canyon speed study data ([EXHIBIT #5](#));
- a copy of 61-8-309, MCA, ([EXHIBIT #6](#)); and

- Traffic Safety Problem Identification report ([EXHIBIT #7](#)).

Director Lynch played a television advertisement depicting the results of an automobile crash in which the occupants were fatally injured.

- 00:35:03 REP. LAKE asked, regarding the US 191 - Gallatin Canyon study, if the Department can provide similar information for other roadways on contributing circumstances. Director Lynch said that the Montana Highway Patrol compiled the information that was used in the study. He referred REP. LAKE to the Traffic Safety Problem Identification report ([EXHIBIT #7](#)) and said that it contains very detailed information on Montana highways.
- 00:36:22 REP. LAKE asked if the aggressive drivers who are frustrated by slower drivers contribute to accidents. Director Lynch said that differential speed promotes aggressive driving and is a factor in accidents.
- 00:38:10 SEN. KITZENBERG discussed several points of concern:
- Wildlife grazing on roadsides creates a significant hazard to drivers. The MDT and other state agencies be more aggressive in pursuing solutions.
 - Montana roads are not safe enough, specifically Highway 2. The Director took a pledge to create a four lane highway from Highway 2. There are several proposals for two lane highways but there has been no action taken to create a four lane highway. The MDT must be more aggressive in pursuing this issue.
 - The highway from Helena to Bozeman also needs to be a four lane highway. It is a heavily traveled road and the passing lanes are ineffective.
 - The EIS done on the road between Fort Belknap and Havre must be reviewed;
 - The feasibility of a four lane highway between Culbertson and the state border should be discussed. Currently, the plan is to build a two lane highway between Bainville and the state line and then study the possibility of a four lane between Culbertson and Bainville. If a two lane is built first and then do a study, it is unlikely that a four lane will ever be built. North Dakota wants to build four lane highways and Montana's cooperation would ensure that a great deal more traffic would travel through this area, resulting in a greatly improved economy for eastern Montana.

TAPE 1 - SIDE B

- 00:43:30 Director Lynch addressed SEN. KITZENBERG's concerns:
- He said that the MDT agreed that wildlife does created driving hazards, but wildlife hazards are unpreventable. The MDT studies wildlife and migration corridors and utilizes wildlife crossings, illuminated signs warning motorists of wildlife crossing areas, and is building a bridge just for migrating wildlife.
 - The MDT has been given an earmark to study Highway 2 and must conduct a feasibility study from Glasgow to North Dakota to determine if a four lane highway is warranted. Federal plans called for the North

Dakota highway project to bypass Montana. Montana asked that federal legislation bring the road into Montana and North Dakota agreed. A feasibility study will be completed before the Bainville to North Dakota highway is constructed and the project is being designed as half of a four lane highway, in anticipation of a four lane road being constructed at a future date.

- It is a very complicated process to reopen an EIS and would best be presented at another meeting to allow for adequate explanation and discussion.

- 00:50:24 REP. MORGAN noted that the highway from Laurel to Rockvale has a higher fatality rate than does US 191. She asked how the MDT determines what highway is the most dangerous. Director Lynch said the residents on US 191 said that highway was the most dangerous highway in the state, not the MDT. The MDT compiled data which demonstrated that it is not the most dangerous highway and presented it to the concerned citizens.
- 00:52:03 REP. MORGAN said that an EIS is under way on the Rockvale Highway. She said that one road may have fewer accidents but a higher fatality rate, versus a road with a higher accident rate but fewer fatalities. She asked how the MDT would determine which highway is most dangerous. Director Lynch said that accident and fatality rates are studied, as are other factors such as wildlife issues, the alignment of the road, shoulder widths, congestion, and differential speeds. Also, small safety projects are done on shorter spans of roadways that have safety concerns.
- 00:54:57 REP. MORGAN asked if the Rockvale Highway is a MDT priority, based on the number of fatalities. Director Lynch said that he did not know and would provide information to REP. MORGAN.
- 00:56:37 REP. LAKE asked what factors can change the start date of a project once the contract has been let. He said he just found out that the Highway 93 has been deferred for four years. Rep. Lake said that this will be a challenge to the residents and he asked why MDT made this decision. Director Lynch said a projected letting date is an estimated date and that other factors can influence the starting date, such as funding, earmarks, state statutes, design process, and right-of-way acquisition.
- 01:00:02 REP. LAKE said \$13 million of federal funding is earmarked for this project. His community is concerned that the project will not get done. Director Lynch said the project is protected, but earmarks don't come in lump sums, but in pieces. Sen. Baucus earmarked many projects - funding is not the reason for delay.
- 01:02:33 SEN. BLACK said the Traffic Safety Problem Identification ([EXHIBIT #7](#)), identifies fatality rates by county. He said he would prefer to have information by highway, particularly in the section of highway between Great Falls and Havre. He asked about plans for improving that stretch of road. Director Lynch said there are plans for portions of that highway and said he would provide more detailed information at a later meeting.

01:05:03 SEN. BLACK said it would be valuable to know which highways have the highest fatality accident rates and would allow the Committee to track the major problem areas. He asked if there is information available for American Indian fatalities and accidents which occur on the reservation. Director Lynch said that there have been problems in the past getting this information and that the MDT is working hard to establish a better relationship with the Tribes.

01:06:35 SEN. ELLIOTT said that he would like Director Lynch to respond to the following information requests at the April meeting;

- the number of citations issued for violation of the open container law since enacted and if the open container violation was the primary reason for the stop;
- statistics on speeding in areas that have non-scientifically established speed limits versus an area that has a scientifically established speed limit; and
- fatality statistics on passenger miles, particularly on multiple fatalities in one vehicle.

Director Lynch said that the MDT gathers information from various sources so it would be difficult to gather information on the passenger miles request but that he would try. He said fatalities per incident could be identified and that would provide good information.

01:09:17 SEN. BLACK asked if the accident and fatality rates include county and state roads. Director Lynch the data includes all roads within a county. He noted that there are over 70,000 miles of roads in Montana, that over 12 billion miles are driven on Montana roads each year, and that 80% of those miles are driven on state highways.

01:10:20 SEN. BLACK asked for a breakdown of the percentage of fatalities that occur on county versus state roads. Director Lynch said he would provide that information.

01:11:02 Director Lynch summarized the information requests received from Committee members: number of citations issued for open container, speeding citations issued on roadways with non-scientific versus scientifically established speed limits, passenger miles in relation to fatalities; and separate out fatalities on state versus county roads.

GENERAL FUND REVENUE UPDATE

01:12:35 **Terry Johnson, Principal Fiscal Analyst, Legislative Fiscal Division (LFD)**, distributed copies of the General Fund Revenue Update for fiscal year 2006 ([EXHIBIT # 8](#) - full text copy) and discussed a power point outline of the report ([EXHIBIT #9](#)). Topics discussed by Mr. Johnson, as outlined in [EXHIBIT #9](#), were as follows:

- Comparison: HJ1 to Now;
- Selected revenue source data for individual income tax, corporation income tax, and oil and gas revenue;
- Underlying economic factors; and
- a summary.

01:15:40 Page 2 - Slide 1: Summary of Aggregate General Fund Revenue;
01:17:16 Page 2 - Slide 2: Comparison of Selected Revenue Sources;
01:20:30 Page 3 - Slide 1: Individual Income Tax Comparison;

TAPE 2 - SIDE A

01:24:18 Page 3 - Slide 1: Corporation Income Tax Comparison;
01:27:20 Page 4 - Slide 1: Oil and Natural Gas Production Tax;
01:28:21 Page 4 - Slide 2: General Fund Revenue by Major Component;
01:29:35 Page 5 - Slide 1: Individual Income Tax Components;
01:31:47 Page 5 - Slide 2: Percent Change in Montana Wages and Salaries;
01:33:27 Page 6 - Slide 1: Montana Capital Gains Income;
01:34:40 Page 6 - Slide 2: US Pre-tax Profits Data;
01:35:53 Page 7 - Slide 1: Crude Oil Prices;
01:38:47 Page 7 - Slide 2: Effective Federal Funds Rate (interest rates);
01:40:28 Page 8 - Slide 1: Effect on Projected FY 2006 Balance of \$227.8 Million.

01:43:15 REP. LAKE said that some states have experienced a major impact on corporate tax receipts due to the effects of the gulf storms. He asked what type of impact could be anticipated in Montana. Mr. Johnson said an extensive analysis of corporate tax data by the LFD made it very clear that what is going with oil and gas tax revenues is very significant and that it is likely that the effects of the gulf storm would not be as significant. He pointed out that there is a lag in receiving data and that factor makes it difficult to make a more definitive statement.

01:45:49 REP. LAKE said that oil and gas companies experienced great losses during the hurricanes and that the large surplus of revenue discussed by Mr. Johnson made him nervous, especially considering the lag in data received. Mr. Johnson agreed, saying that while Montana is experiencing growth, he is still cautious.

01:47:07 SEN. TOOLE said that he is troubled by the concept that oil and gas companies took a big hit in the gulf storms. He said that his impression was that profits are at a record high. He said that big price spikes in oil and gas have occurred and that he doesn't understand why. He asked if this is due to the natural function of the markets or if costs really are increasing. Mr. Johnson agreed that prices have increased considerably. Natural gas spiked several months ago but is abating now. Oil prices have also increased but Mr. Johnson said that he does not anticipate those prices to decrease soon. He said he did not know if costs have increased but said that investments may be a factor.

01:49:57 SEN. TOOLE asked if Montana has the capability to look at the pre-tax profits and determine how much is coming from the energy sector. Mr. Johnson said that to some degree, underlying corporate tax information can be examined, but the problem is the lack of access to some corporate tax data. Confidentiality restrictions prevent the LFD from assessing certain information that would be helpful.

- 01:52:40 SEN. ELLIOTT asked to what extent do taxes track the pre-tax profit. Mr. Johnson said he tries to disaggregate the tax return data into in-state corporation tax data and multi-state corporation tax data. The LFD thinks there is a high correlation between multi-state corporations and US pre-tax profits.
- 01:54:10 SEN. KITZENBERG said that the estimates of oil revenue may be incorrect because active oil fields are bigger than anticipated. The leasing activity is increasing, rather than stabilizing. Mr. Johnson said that a substantial amount of additional oil and gas revenue was built into the budget, but that other factors, such as transportation of the commodity, could have an effect on the revenue.
- 01:57:13 SEN. BLACK asked why there is such a substantial decrease in audit collections. Mr. Johnson said that the comparison is based on a very robust year and that there is a lag in the recording of the audit revenue in the accounting system.
- 01:59:46 **Dan Bucks, Director, Department of Revenue (DOR)**, said since conversion from the POINTS system to the IRIS system has occurred, there is more staff time and resources available for audit duties and predicted that audit collections would increase. Other factors also have influenced reporting of audit collections data, such as the lag between collecting and recording the revenue and the different accounting rules in the IRIS system.

TAPE 2 - SIDE B

ACCESS TO TAX AND REVENUE INFORMATION

- 02:05:30 **Clayton Schenck, Legislative Fiscal Analyst, LFD**, said that the Revenue and Transportation Interim Committee requested that Director Bucks work with the LFD to resolve the problem of access to confidential tax information. RTIC and the Legislative Finance Committee sent letters requesting that:
- legal interpretation of both state and federal law be addressed;
 - that a clear procedure for access that is mutually agreeable be developed;
 - that access of legislative staff to data cubes in the new IRIS system be addressed; and
 - that legislative staff draft legislation to clarify the statutes, to reduce disputes in the future.
- Mr. Schenck thanked the Committee for its support and guidance in resolving this issue and said that great progress has been made. The final details of a draft Memorandum of Understanding (MOU) are being worked out. He expressed gratitude to Director Bucks for the cooperation shown by the DOR and thanked Greg Petesch, LSD Counsel, and Dave Ohler, DOR Counsel, for their work on the MOU.
- 02:12:29 Director Bucks said that Mr. Schenck's report accurately reflects the cooperation and effort made by both agencies to resolve the issue. He noted that federal requirements often override state statute, which was a contributing factor to the LFD's difficulty in accessing information. He said that he is very pleased with the agreement and that, with the exception of data protected by federal law, the LFD

and other agencies should be able to get whatever information is needed in a timely manner.

02:17:43 Mr. Martin said that a list of the confidentiality statutes has been distributed to the members ([EXHIBIT #10](#)). He discussed the pertinent points regarding access to information and said that Mr. Schenck and Director Bucks think that any proposed legislation by the Committee be reached by consensus between the DOR and the LFD. He suggested that legislation be by the request of all of the affected agencies.

02:21:47 SEN. ELLIOTT agreed that having consensus on the proposed legislation is important and that it is his hope that the Committee would also reach consensus.

DEPARTMENT OF REVENUE UPDATE

02:36:44 Director Bucks distributed an outline of the topics he planned to discuss ([EXHIBIT #11](#)):

- the endowment credit;
- property taxes;
- cigarette taxes;
- tax administration; and
- income tax compliance.

Director Bucks provided a letter stating that, as required by 15-1-230, MCA, the DOR has provided the 2005 report on the Charitable Endowment Credit Legislative History and Use to the RTIC. He distributed copies of the 2005 report to the Committee ([EXHIBIT #12](#)).

Director Bucks discussed a recent DOR ruling allowing the use of charitable contributions to an endowment fund for the construction of buildings. He said that initially the Department opposed allowing this, but after reviewing the Uniform Management of Institutional Funds Act in Title 72, it reconsidered and ruled that it was allowable. Members of the charitable and philanthropic community have objected to the ruling so a Governor's Task Force on Endowed Philanthropy is meeting to draft legislation to clarify the statute. Director Bucks said he would be working with the Task Force on the proposed legislation.

02:45:44 Director Bucks discussed a time line for completion of property reappraisal ([EXHIBIT # 13](#)). He said that Committee input and comment is needed and welcome. Committee members are invited to learn more by reviewing the appraisal process for their own property. Director Bucks asked interested members to provide advance notice to DOR so that a computer terminal could be set up and staff could be scheduled to assist them.

Director Bucks said that Governor Schweitzer will announce his appointments to the Agricultural Advisory Committee soon.

Director Bucks briefly discussed District Court Judge Jeffrey Sherlock's ruling in the Omimex case. Both the DOR and the Omimex motions for summary

judgment were dismissed by Judge Sherlock and a hearing date was set for September 18, 2006.

- 02:53:15 Director Bucks presented information relating to the cigarette tax and discussed the following:
- cigarette tax stamp sales for 2002-2005 ([EXHIBIT #14](#)) and how the combined effect of reduced smoking and the increase in illegal purchases contributed to the change in tax revenues;
 - what is being done to combat illegal cigarette sales in Montana;
 - major credit card companies have agreed to stop providing services to Internet cigarette sales companies;
 - shippers have stopped shipments to private individuals;
 - UPS signed an agreement that it will ship only to registered retailers; and
 - the Department of Justice and local law enforcement personnel are actively pursuing violations of the law.

Director Bucks said that the new method for negotiating state-tribal revenue sharing agreements is working well. He discussed the new agreements with the Chippewa Cree Tribe.

TAPE 3 - SIDE A

Director Bucks reported that the DOR is working cooperatively with the Department of Justice and the Department of Public Health and Human Services on all tobacco initiative matters.

- 03:04:59 Director Bucks distributed and discussed a sample of the new Statement of Account Monthly Mailing ([EXHIBIT #15](#)), implemented as a part of the IRIS system. The monthly billing process was initiated on November 1, 2005, and appears to be effective because payments are being made more promptly.
- 03:10:23 Director Bucks reviewed the IRIS Phase III Schedule ([EXHIBIT #16](#)). He invited the Committee to visit the Department to view how tax returns are processed through the new system.
- 03:14:33 Director Bucks discussed a United States attorney letter regarding illegal tax shelters ([EXHIBIT #17](#)), saying that illegal tax shelters are the number one tax compliance problem in the nation. The DOR has started collection proceedings against companies with a record of using illegal tax shelters; some taxpayers have come forward voluntarily but most have stonewalled. Collection proceedings will be time-intensive and will require complicated legal enforcement procedures and would be a great deal easier if Montana has statutes similar to those of the federal government, which require disclosure of activities. Until Montana gains the tools or the resources to correct this situation, it is the taxpayers who will have to bear the burden.

DAY ONE - PART TWO

BUSINESS INCOME TAXES

Pass Through Entities and Domestic Corporations

- 00:00:02 **Joe Shevlin, Certified Public Accountant**, discussed passthrough entities and domestic corporations ([EXHIBIT #18](#)). Specific topics discussed were:
- C - corporations;
 - S - corporations;
 - partnerships;
 - limited liability companies (LLC);
 - limited liability partnerships (LLP);
 - disregarded entity;
 - entity selection; and
 - Montana requirements for a flow through entity.
- 00:05:02 SEN. TOOLE, asked about the double taxation of C-corporation dividends. Mr. Shevlin said that a corporation must pay taxes on its net income and that if the income is then distributed to shareholder as a dividend, that shareholder will be taxed on it also.
- 00:05:40 SEN. TOOLE said that no entity is actually being taxed twice. Mr. Shevlin said that was correct, it is two different entities being taxed on the same dollar, and that the term "double taxation" is an accounting term used in reference to a C-corporation paying dividends.
- 00:08:02 SEN. ELLIOTT questioned how a corporation determines its calendar or fiscal year. Mr. Shevlin explained that a C-corporation is free to establish its own calendar year but that an S-corporation's calendar year end must adhere to the year-end that the majority of its shareholders have.
- 00:16:27 SEN. ELLIOTT asked Mr. Shevlin to explain why a disregarded entity is named that. Mr. Shevlin said the "entity" is really just an individual, so the "entity" is disregarded.

TAPE 3 - SIDE B

- 00:20:58 REP. COHENOUR asked how backup withholding is used to ensure that taxes owed to the state are paid by nonresident shareholders of a pass through entity. Mr. Shevlin explained that backup withholding is one of three ways a nonresident shareholder may pay Montana taxes and is really a deposit paid by the shareholder. The deposit may be used against the amount of taxes owed in the event the taxes are not paid by the nonresident.
- 00:22:24 REP. COHENOUR asked how information on income generated in Montana is reported to either the federal government or to other states. Mr. Shevlin said that it is the responsibility of each individual to report the individual's share on the income to the federal government or in the state in which they reside.
- 00:24:54 SEN. BLACK asked if a limited liability company (LLC), whether taxed as a corporation, a partnership, or an individual, receives liability protection. Mr. Shevlin said if the entity is an LLC or an LLP, by law, they have liability protections.

- 00:25:41 REP. MCALPIN asked what other changes were made as a result of HB 143 and what the purpose of the changes were. Mr. Shevlin said that the bulk of the changes were intended to deal with pass through entity rules and how to make the mechanism work better.
- 00:26:47 SEN. ELLIOTT, referring to Page 14 of [EXHIBIT #18](#) - entity selection list - asked for examples of why a business might choose a particular entity form. Mr. Shevlin said C-corporations are usually larger corporations and may have ongoing life. A company that wants to be publically held will choose to be a C-corporation because the structure of a C-corporation lends itself to people moving in and out of the corporation and has some benefits for passing on ownership through a gifting process.
- 00:28:34 SEN. ELLIOTT asked, when discussing the passing of ownership, if that is referring to a farm or ranch. Mr. Shevlin said that there a number of agricultural operations that use a C-corporation and one of the main reasons for that is because it is easy to pass ownership of property. Mr. Shevlin said that his personal opinion is that real property should not be held in C-corporations because there can be devastating tax effects should the operation be sold or liquidated.
- 00:29:56 Mr. Shevlin said that smaller operations are well suited to be an LLC or an LLP because they still get protection from liability and they are easy to set up and administer. S-corporations are not used as much now because LLCs and LLPs have become more prominent.
- 00:31:52 REP. LAKE asked Mr. Shevlin to explain the ease or difficulty of moving between these entities. Mr. Mr. Shevlin said it has become easier to move with the federal "check the box" option. He said his opinion is that an entity gains little by changing from one type of entity to another.

Multistate Corporations

- 00:34:57 **Mike Green, Attorney-at-Law**, said that differences in a business's needs is the main reason for choosing the entity type. Mr. Green said that he is appearing before the Committee as a private citizen and not as a representative of a particular business or organization. Mr. Green discussed many aspects of Montana's taxation of multi-state corporations ([EXHIBIT #19](#)), which included:
- the need for a worldwide combined reporting statute;
 - the need for a definition of worldwide combined income;
 - disagreement regarding apportionable versus allocable income;
 - inadequacies of the three factor formula (income apportioned by averaging sales, payroll, and property);
 - the national trend away from uniformity and problems associated with the lack of uniformity; and
 - the confidentiality of tax information.

TAPE 4 - SIDE A

- 01:07:42 SEN. ELLIOTT questioned Mr. Green about the problems in formulary apportionment as it is applied to cable versus satellite television companies and the differences in how each earn income. Mr. Green said that cable companies feel that they have been forced to make upgrades in their equipment in order to compete with satellite companies. The upgrade may substantially increase the cable company's book value but has no impact on its revenue. On the other hand, equipment upgrades at a coal mine would significantly impact revenues because of the increased capacity for production.
- 01:16:57 SEN. ELLIOTT, referring to Mr. Green's statement that the three factor formula has no scientific basis, asked if there is an apportionment formula that is based on science. Mr. Green said that there is not and that the formula can't be applied to all situations. SEN. ELLIOTT asked if a separate formula could be used for each industry given the variety of industries and the rapid changes that industries now go through. Mr. Green said he did not know if it could be done, it would be very difficult to do administratively, but would be fair if applied uniformly.
- 01:24:28 REP. MORGAN asked about the lawsuit to allow access to corporation tax information. Mr. Green said that the parties to the lawsuit are Senator Jim Elliott and the defendant is the Montana Department of Revenue. Mr. Green said that his client, the Montana Taxpayers' Association, has intervened in the lawsuit, as have several other interested parties.
- 01:25:03 SEN. ELLIOTT said that it is constitutional issue. He discussed the 1913 *Flint vs. Stone Tracy* case, in which the constitutional test case was rejected by the United States Supreme Court.
- 01:27:51 SEN. TOOLE said that many people are surprised to learn that corporations have the same privacy protections as private citizens. Mr. Green said that corporations do not have the same rights as an individual possesses under either the state or federal constitution, but for purposes of administrative convenience and expediency, have been treated as persons under the law.
- 01:31:14 SEN. TOOLE said that it is his opinion is that corporations do have the same rights as individual citizens, such as freedom of speech and to privacy. SEN. ELLIOTT's legal challenge is interesting because it goes to the Montana Constitution, which very specifically establishes the right of privacy to persons. Mr. Green agreed that corporations have freedom of speech but also have certain restrictions, such as campaign contributions and participation in a political campaign.
- 01:33:22 SEN. TOOLE said that same restriction applies to individuals and is not really a distinction. As policymakers, legislators are tasked with trying to determine a fair way to implement a taxation system. Not having specific information on what is going on within corporate America and the economy makes it very difficult for legislators to do their job.

TAPE 4 - SIDE B

Mr. Green said he isn't sure how information about a specific corporation would help legislators craft a fair and uniform tax policy. He said the corporate entity is an extension of its owners, that the information doesn't belong to the corporation, it belongs to the owners; and he feared that the protections currently provided to these groups of businesses will be destroyed.

01:36:35 SEN. ELLIOTT said that the Supreme Court has ruled that corporations do not have the expectation of the right of privacy. He said he is not interested in small corporations or family held corporations and would discourage others from looking at their records.

01:39:25 SEN. ELLIOTT said that residents of Wisconsin can mail \$4 and the name of a corporation to the Wisconsin Department of Revenue and receive a report on how much that corporation paid in Wisconsin taxes.

Five Problem Areas of Business Income

Dan Bucks, Director, Department of Revenue, said that his presentation is in response to Sen. Kitzenberg's request for information regarding the five greatest business income issues facing the DOR. He said the Department's perspective is that every business should be as equally accountable for the income that it earns in Montana as possible and that none should gain an advantage over another in the marketplace due to quirks in the tax law or failures of compliance. Director Bucks distributed a prepared list of the five problem areas of business income tax issues ([EXHIBIT #20](#)) and discussed each item on his list:

- abusive tax shelters;
- corporate tax loopholes;
- abuse of trusts and an example of an abuse case ([EXHIBIT #21](#));
- unreported income earned in Montana; and
- pass-through entities.

02:07:07 REP. MORGAN said many of the problems expand beyond Montana's jurisdiction and asked what Director Bucks plans to do. Director Bucks said that Montana laws can be fixed to deal with many of the problems. Even though only a small percentage of the taxpayers engage in these activities, it has a significant fiscal impact on the state. Some corporations are particularly abusive, which creates an unfair tax atmosphere for the businesses that are trying to be good citizens.

TAPE 5 - SIDE A

02:09:57 REP. LAKE asked Director Bucks if he sees his role as making sure that all corporations have an equal opportunity for making a profit in Montana. Director Bucks said it is the DOR's responsibility to administer tax policy fairly and equitably.

02:11:07 REP. LAKE, regarding Director Bucks' statement that companies that operate in Montana should be taxed on the income it earns in Montana, noted that Montana is a unitary taxing state, which would entail a different calculation method. Director Bucks said REP. LAKE was correct and that when dealing with an

enterprise that crosses state and national boundaries, formula apportionment is an equitable method to determine the income earned in a state.

- 02:13:05 REP. LAKE asked how can Montana slow or stop the incidence of abusive tax shelters without destroying the opportunity for use of legitimate tax shelters. Director Bucks said corrective action would target a very small number of taxpayers and would not disrupt the tax system.
- 02:15:30 REP. LAKE said if penalties should be considered to reduce the number of abuses. Director Bucks said that the abuse is being done almost exclusively by out of state companies and nonresidents and agreed that there should be penalty for tax abuse. These are not cases where ordinary use of the code is occurring, this is completely false activity and has a major impact.
- 02:17:26 REP. LAKE said that the current tax code allows people to generate and protect income, which generates wealth. That must not be destroyed because of people who stretch their interpretation of Montana tax policy. He asked Director Bucks if he would agree that the tax code is not wrong, but that it is being misused. Director Bucks agreed.

MONTANA SOURCE INCOME RULE

- 02:35:19 Director Bucks said that because of the great amount of public interest in the Montana source income rule, the DOR consulted with experts on the legal interpretation and for additional perspective. He introduced Walter Hellerstein ([EXHIBIT #22](#)) and Vern Hoven ([EXHIBIT #23](#)) and reviewed their expert credentials. (*Both Mr. Hellerstein and Mr. Hoven spoke to the Committee via teleconference.*) Director Bucks reviewed how Montana taxes nonresidents on deferred gain on property sales ([EXHIBIT #24](#)) and reviewed sections of the Montana tax code: 15-30-101, MCA; 15-30-105, MCA; 15-30-111, MCA; and 15-30-131, MCA, ([EXHIBITS #25, #26, #27, and #28](#)).
- 02:47:41 **Walter Hellerstein, Professor, University of Georgia School of Law**, said that in his opinion, Montana statute is absolutely clear in taxing income which originates in the state and that enforcement of the statute is the only issue that needs to be resolved.
- 02:49:34 REP. MCALPIN asked for a comparison of similarly situated states. Mr. Hellerstein said the law in virtually all states is that this type of income is taxable. He also discussed that some states impose an exit tax instead, which in Mr. Hellerstein's opinion, is illegal.
- 02:51:25 REP. LAKE said that there is a difference between a real estate "sale" and a 1031 "exchange". He asked if any other states are doing what DOR is proposing to do in tracking 1031 exchanges. Mr. Hellerstein said if a state of residence imposes a tax on income recognized for federal purposes and there is also a tax imposed by a nonresident state, the taxpayer gets a tax credit. Mr. Hellerstein said the difference between a sale and an exchange is irrelevant.

- 02:53:48 **Vern Hoven, Certified Public Accountant**, said that REP. LAKE's question was a practical question from a tax preparer's perspective. This same question recently came up at a recent tax seminar. Mr. Hoven discussed a detailed example: A Montana citizen buys Montana property for \$100,000 and decides, when the property is worth \$300,000, to move to Idaho. The \$300,000 Montana property is traded for a \$300,000 property in Idaho. At that time, the taxpayer files a form 8824 which calculates the amount of the gain (\$200,000) as if the taxpayer had sold the property for cash. This is the difference between "realized" and "recognized" because while income was recognized, none of it has to be reported under a 1031 exchange. If the Idaho taxpayer sells the property for \$600,000 cash, that is a taxable event. There is a \$500,000 gain on the original purchase of property in Montana to the cash sale of the property in Idaho. Mr. Hoven asked if it would be fair for Idaho to tax the entire gain, when \$200,000 of it occurred in Montana. The Montana Department of Revenue's position is, that when property is sold, only the amount of gain realized in Montana is taxable. In this case, \$200,000 of gain would be reported to Montana.
- 02:58:33 REP. LAKE asked what happens if 20 years elapses between the time when the property was purchased in Montana and sold in Idaho; or if the original purchase occurred in California and the cash sale took place in Montana. Mr. Hoven said that Idaho will tax the \$500,000 gain, but it is only fair that Montana tax \$200,000 of the gain. So, \$200,000 is being taxed twice - once in Idaho and once in Montana. Most states allow the taxpayer a credit in their resident state. Mr. Hellerstein said the problem of double taxation is non-existent at the personal income tax level. Every state gives its residents a credit for taxes paid to other states. Mr. Hoven said that if the example he discussed was reversed, Montana would tax the \$500,000 gain but that the tax paid to Idaho becomes a credit on the Montana return.
- 03:01:45 REP. LAKE said factors such as moving to a nonincome tax state or a significant delay between sales or exchanges makes it almost impossible to follow. REP. LAKE asked what happens if the investment results in a loss. Director Bucks said the proposed follow-up rule provides for this event. Montana source income is the amount of the original gain in Montana or the amount of the federally recognized gain, whichever is less. If subsequent losses diminish the final gain when the deferral expires, the Montana gain is reduced for those losses.

TAPE 5 - SIDE B

- 03:05:09 Director Bucks said he wanted it to be clear that DOR views the law, as it has existed since 2002, as that if a nonresident ends a transaction in Montana, Montana picks up only the amount of the gain that originates in the state.

REP. LAKE asked Mr. Shevlin how certified public accountants are handling the final disposal of property into Montana. Mr. Shevlin said he has not prepared a tax return with a culminated 1031 exchange. He said his best guess would be that if the taxpayer is a resident of Montana, the entire gain would be taxed in Montana. If the taxpayer is a nonresident, the tax may be bifurcated.

- 03:07:02 Director Bucks said that residents report 100% of their income from all sources in calculating their Montana tax. If any income is taxed by a foreign country or by another state, the resident gets a tax credit on their Montana taxes. Regarding nonresidents, Montana law does not allow picking up prior gains that occurred outside of Montana before property was initially purchased in this state.
- 03:09:21 Mr. Hellerstein said that other states have imposed an exit tax on 1031 exchanges out of concern of losing income from departing residents but that he thinks this is unconstitutional.
- 03:10:58 REP. COHENOUR asked Mr. Hellerstein to comment on the potential effect of a long time span on a 1031 exchange. Mr. Hellerstein said that records are maintained, so length of time should have no impact on a 1031 exchange. Mr. Hoven said that the taxpayer must keep up the 8824 forms, which will keep record of any gains. The only reason income would disappear would be because someone didn't want to report it.
- 03:12:37 REP. LAKE said that it is very difficult for a state to collect on a long-term 1031 exchange if the state does not have a tracking mechanism in place. Mr. Hellerstein said that taxpayers have no problem tracking this for as long as is appropriate in order to maximize their tax advantages.
- 03:14:38 Mr. Hoven said it is an enforcement problem and the DOR must find a solution.
- 03:15:04 Director Bucks said that it is not difficult for DOR to determine the amount of the transaction because the 8824 form indicates that. The difficulty is whether DOR can stay in touch with the taxpayer, after the taxpayer has left the state. DOR is working to establish cost effective methods of staying in touch with 1031 exchange taxpayers who leave the state. Annual letters will be sent to the taxpayer and the Department is investigating the possibility of exchanging information with other states in order to maintain contact with the taxpayer.
- 03:18:27 SEN. ELLIOTT asked why Mr. Hellerstein thinks an exit tax is unconstitutional. Mr. Hellerstein said that he may be wrong about the constitutionality, but based on his reading of the Commerce Clause and of the Privileges and Immunities Clause, he thought that an exit tax would be struck down as discriminatory against people who leave the state.
- 03:20:09 REP. COHENOUR asked Mr. Hellerstein and Mr. Hoven if they believe that Montana statute provides equity between residents and nonresidents. Mr. Hellerstein said yes. Mr. Hoven said that he thought Montana law to be fair and discussed the reasons for his opinion.
- 03:23:24 SEN. BLACK said that Mr. Shevlin testified against the proposed rule at the administrative rule hearing on December 28, 2005. He asked Mr. Shevlin if DOR's revisions had changed his opinion. Mr. Shevlin said his opposition is not what was being done, but how it was being done and the implications of enforcement and possible effects on neighboring states that don't treat the gain

the same as Montana. He has concerns about the administration of this rule and that he would like more information on what the state is losing on outbound 1031 exchanges.

03:26:38 SEN. BLACK asked Director Bucks to respond. Director Bucks said that because the Department has not been tracking 1031 exchange transactions, there is not much data. He said that the most common complaint he has received since taking the job as director has been about this issue and that there is much interest in making nonresidents pay their fair share of taxes. Director Bucks said this rule does not require any new calculations and does not place a burden on the taxpayer.

03:32:19 REP. MORGAN asked Director Bucks to estimate an amount that Montana may be losing in revenues because this law has not been enforced. Director Bucks said that there is no way to know until the rule is administered and revenue collected. The Department does know that there are significant land sales involved in 1031 exchange transactions. As deferrals expire and the rule is fully implemented, more will be learned.

03:33:30 REP. MORGAN said that there may not be as much revenue collected as expected, because in her experience, most people never finalize a 1031 exchange because they don't want the tax consequences.

03:34:32 Director Bucks said that, judging from the volume and amount of land sales taking place in Montana, he believes there is substantial revenue involved.

03:35:26 SEN. ELLIOTT said he would like an explanation of economic impact statement (EIS). **Larry Finch, Administrator, Tax Research and Policy Office, DOR,** said that much of the EIS has been discussed during the meeting. A concern that the rule would have a huge and adverse impact on the Montana economy will not materialize because this issue does not involve Montana residents. This issue mainly involves nonresidents living in states with no income tax and who are involved in 1031 exchanges. There is no information available at this time on how many people fit into this category but Mr. Finch estimated that it will be fairly small number. As DOR considered the options for addressing this issue, it was urged by some interested parties to simply do nothing. **TAPE 6 - SIDE A** DOR did not consider this for several reasons, such as the fact that it would give nonresidents an economic tax advantage in competing with land purchasers in Montana who have to pay the tax. Mr. Finch said that DOR will not apply the Montana source income rule to a nonresident's gain that is attributable to another state and that any amount of gain that is recognized in Montana will never exceed the total amount of gain that is ultimately recognized.

Mr. Finch said that the EIS required consideration of the following:

- the probable economic impact;
- the probable costs and implementation of enforcement;
- the costs and benefits of the proposed rule;
- to research alternative methods; and
- efficiency in allocating public and private resources.

Mr. Finch said requiring nonresidents to be subject to the same tax treatment as residents minimizes distortions in investment decisions, adds equity to Montana's tax structure, and assures that the Department, when administering the laws, provides all affected persons with the equal protection of the law under the Montana Constitution. Information on what amount of dollars this will provide to Montana is unknown but there is evidence that indicates that it may be substantial, perhaps as much as several million dollars.

03:48:35 **Lee Heiman, Staff Attorney, LSD**, discussed the sufficiency of the economic impact statement ([EXHIBIT #29](#)). He said because there will be no change in the administration of the law, there is no real economic impact.

PUBLIC COMMENT

03:50:46 **Jim McGarvey, Montana AFL-CIO**, testified that the AFL-CIO is in support of the enforcement of the Montana source income rule ([EXHIBIT #30](#)).

03:52:53 **Don Judge, Teamsters Local 190**, distributed copies of remarks from Mary Caferro, representing Working for Equity and Economic Liberation (WEEL), in support of DOR's efforts to enforce the Montana source income rule ([EXHIBIT #31](#)). Mr. Judge testified in support of the proposed rules on behalf of the Teamster's Union Local No. 190 ([EXHIBIT #32](#)).

03:57:13 **Tom Biladeau, MEA-MFT**, testified that the MEA-MFT supports enforcement of the Montana source income rule and urged implementation without further delay.

03:58:07 **Stan Fraser, Montana Wildlife Federation**, said the MWF is in support of the changes. Mr. Fraser said, as a realtor, he knows that the Montana Association of Realtors opposes the proposed rule, but also thinks that most realtors do not oppose the proposed rule.

04:00:14 Mr. Shevlin asked to make several comments:

- the Montana Society of CPAs stated their concerns about the proposed rule but that once DOR passes the rule, it will be followed;
- how a 1031 exchange sale is tracked depends on whether or not it originates in state or out of state;
- regarding the economic impact study, taxpayers who don't pay state taxes are not at an economic advantage;
- the potential for revenue collected from the cash out of 1031s, as discussed by Mr. Finch, are greatly exaggerated; and
- the rules for a 1031 exchange sale on personal property are very stringent and if this property is not being taxed, it is not due to the use of a 1031 exchange sale.

04:05:40 **Mary Whittinghill, Montana Taxpayers Association**, agreed that there are many perceptions about nonresidents and failure to withhold taxes. Ms. Whittinghill said that she is still of the opinion that, prior to 2001, there was not clarity that this was going to apply to 1031 recognition of income. She said that she was not disagreeing necessarily with the testimony of Dr. Hellerstein but that

she wants to make certain that Montana stays in sync with other states. She said she is glad that the DOR is trying to clarify its collecting mechanism because this has been an unresolved issue for all involved.

04:08:10 **Glen Oppel, Montana Association of Realtors**, said that the Montana Association of Realtors has looked at this issue very seriously. The Association has a legislative committee made up of 25 members, which makes decisions in the best interest of the real estate industry. Mr. Oppel said the Association's position is that this is a serious change in tax policy in Montana and should be looked at by the Legislature.

04:09:26 SEN. ELLIOTT asked Mary Whittinghill, regarding HB 143 (2001), if she meant that the bill did not intend to define "deferred gain" as Montana source income. Ms. Whittinghill said that she sat through the subcommittee hearings and the ad hoc working group, and that most of the discussion pertained to clarification on passthrough income for passthrough entities. In her recollection, there was not a discussion on the collection mechanism for 1031 exchanges sales when a taxable event occurred. SEN. ELLIOTT asked if Ms. Whittinghill thought, since that was not addressed in HB 143, that deferred income by Montana residents should not be recognized as Montana source income. Ms. Whittinghill said this issue was addressed in the 2005 session to clarify it and to add a collection mechanism. The MTA wants to be sure there is equity for all taxpayers, resident and nonresident alike. This is a complicated issue that needs to be addressed legislatively.

04:13:03 SEN. ELLIOTT asked if Ms. Whittinghill disagrees with the Committee's legal staff legal opinion, which is that this is an interpretive rule and entirely within the purview of DOR to make under existing legislation. Ms. Whittinghill said she is not disagreeing with staff, only that the past Montana practice on this particular issue will be changed as a result of this rule and there is a lot of confusion over how to proceed.

COMMENT ON PROPOSED RULES TO CALCULATE MONTANA SOURCE INCOME

04:14:20 Mr. Heiman continued his discussion of his evaluation of the proposed rules and explained the provisions of the proposed rule changes ([EXHIBIT #29](#)).

No public comment was given.

SEN. ELLIOTT recessed the Revenue and Transportation Interim Committee until February 17, 2006.

DAY TWO - FEBRUARY 17, 2006

TAPE 1 - SIDE A

PART ONE

SEN. ELLIOTT reconvened the Revenue and Transportation Interim Committee at 8:05 a.m. He noted the presence of a quorum and asked the secretary to note the roll. SEN. BLACK,

SEN. KITZENBERG, SEN. TOOLE, SEN. ELLIOTT, REP. MCCALPIN, REP. COHENOUR, and REP. LAKE were present; SEN. BARKUS, SEN. GILLAN, REP. HINER, REP. MORGAN, AND REP. WAITSCHIES were absent/excused ([ATTACHMENT #3](#)).

HOUSE JOINT RESOLUTION 44 - STUDY OF PROPERTY TAXATION OF OIL AND NATURAL GAS PROPERTY

Operations of Oil and Natural Gas Production Companies

- 00:00:02 **ENCORE OPERATING, L.P., Bob Jacobs**, discussed a power point presentation ([EXHIBIT#33](#)). Topics discussed by Mr. Jacobs included:
- a brief business history of Encore Operating, LP;
 - operations of oil and natural gas;
 - specific details of the Cedar Creek Anticline (CCA);
 - ▶ oil and gas wells,
 - ▶ maps of oil operations of the CCA,
 - ▶ map of gas operations of the CCA; and
 - revenue resulting from oil and gas operations.
- 00:10:04 REP. MCALPIN asked if advances in technology have made it or will make it easier to recover oil. Mr. Jacobs said that technology has advanced but it is more a matter of whether a well is an economically viable project.
- 00:11:26 SEN. BLACK asked about the expected life of the Cedar Creek Anticline (CCA). Mr. Jacobs said production should increase for the next few years and remain stable for many years, possibly for several decades.
- 00:12:59 SEN. BLACK asked for a forecast for the price of oil. Mr. Jacobs said that there is no way to know what the market will do, so ENCORE intends to stay as flexible as possible in order to absorb the swings that occur in business.
- 00:15:07 SEN. TOOLE asked if there is a pump at each well or if a pumping station is used to inject water into the wells. Mr. Jacobs said that a central facility is used to gather and energize the water before sending to a well. The water is injected at a very high pressure and replaces the oil as it is removed because the pressure in the reservoir must be maintained. Air injection is a slightly different technique because it pushes the oil out of the reservoir. In order to inject it into a well, the air is highly pressurized at a central compression facility, then sent out by truck and injected into the well. The high pressure allows the oil to flow at a better rate.
- 00:16:33 SEN. TOOLE asked if the pressure has to be maintained underground and if a valve system is used to maintain pressure. Mr. Jacobs said that once a well is injected, the pressure does have to be maintained in order to keep the oil flowing.
- 00:17:38 SEN. TOOLE asked if electricity is a major cost for ENCORE and who the supplier is. Mr. Jacobs said that electricity is ENCORE's single largest expense and that Montana Dakota Utilities (MDU) is the supplier.

00:18:57 SEN. TOOLE said that ENCORE's need for electricity is constant and could not deal with intermittent supplies of electricity. Mr. Jacobs said that was correct.

00:19:27 SEN. TOOLE asked Mr. Jacobs to explain carbon sequestering. Mr. Jacobs said that CO 2 injection is an effective tertiary process because it increases oil production, but that it is cost prohibitive to use at the CCA site, so ENCORE chose to use air injection instead. ENCORE is very interested in pursuing carbon sequestering but won't take further action until CO 2 sources become more economical.

00:22:15 SEN. ELLIOTT said that Encana is using that technology in Alberta, Canada, and is purchasing the CO 2 from a North Dakota power plant. He asked if there was a representative from Encana present at the meeting. There was not.

00:22:38 SEN. TOOLE asked if Mr. Jacobs would agree that the main obstacle to using carbon sequestering is the economics. Mr. Jacobs said he would agree with that assessment and that the bottom line is the deciding factor when choosing which technology to use.

00:25:56 REP. LAKE said that the presence of ENCORE has greatly contributed to Montana's economy and asked Mr. Jacobs to discuss ENCORE's future plans in Montana. Mr. Jacobs said that Encore has invested \$496 of capital directly into its Montana operations through year end of 2005 and that ENCORE intends to invest another \$115 million into the CCA in 2006. ENCORE is continuing to study Bell Creek and will likely invest there as well.

0:28:47 REP. LAKE said that he appreciated the investments and suggested that there should be adjustments made for ENCORE as an incentive to use CO 2.

00:31:25 SEN. ELLIOTT asked if ENCORE owns property in Richland County. Mr. Jacobs said no, but that ENCORE does have involvement in the Bakken plant, as well as other investments in Montana.

00:32:21 SEN. ELLIOTT asked how many miles of ENCORE flow lines there are in Montana. Mr. Jacobs estimated that there would be hundreds of miles, in increments from a well to a facility. SEN. ELLIOTT asked how many flow lines cross county lines. Mr. Jacobs said didn't know but would find out. SEN. ELLIOTT said the Committee would like to know because central assessment of lines is a task before the Committee. Mr. Jacobs said that ENCORE's pipelines have been used for transporting what ENCORE produces to places operated by ENCORE before being turned over to a transmission company and marketed. While better defining what a flow line, gathering line, transmission line, and marketing line is would be useful, historically ENCORE has been locally assessed and it is ENCORE's position is that it should remain that way.

00:35:13 SEN. ELLIOTT asked what proportion of ENCORE's wells are tertiary and secondary. Mr. Jacobs estimated that about a third of the wells are either secondary or tertiary. SEN. ELLIOTT asked how many new wells are being drilled. Mr. Jacobs said that 420 new wells have been drilled on the CCA since

1999 and that ENCORE contracts with 27 workover rigs to keep the wells producing. Reentry technology has also been used on existing wells. **TAPE 1 - SIDE B** SEN. ELLIOTT asked if it is difficult to obtain drilling rigs. Mr. Jacobs said that as demand has picked up, it has been more difficult to find rigs and has also resulted in increased service costs.

00:39:24 SEN. ELLIOTT said that when a new well is drilled, the line has to be filled and transported to a central point and asked what the cost per mile is. Mr. Jacobs said that he didn't know but would get that information to the Committee. SEN. ELLIOTT said the Committee would like to have that information.

00:40:02 SEN. ELLIOTT said that taxes are a fixed cost of doing business. Mr Jacobs said that is correct but that variables, such as the price of oil and the capital investment for drilling new wells are difficult to project, so it is still difficult to set a budget.

00:42:35 REP. LAKE asked that ENCORE to identify what the "break even" amount would have to be in order to be profitable, in order to use that figure as an incentive to the supplier. Mr. Jacobs said that he wasn't sure that ENCORE could do that because it may be proprietary information but that ENCORE would provide whatever information it could.

Interstate Comparisons on Assessment Procedures for Oil and Natural Gas

00:47:06 **Jeff Martin, Legislative Research Analyst, Legislative Services Division,** presented a report on the valuation of oil and natural gas property in selected states ([EXHIBIT #34](#)). Mr. Martin's report summarized how other states value oil and natural gas production, the state agency responsible for the valuation, and the valuation method used. States included were Wyoming, Kansas, Mississippi, Michigan, Ohio, California, Louisiana, and Alabama. Mr. Martin reviewed the information he gathered for each state.

TAPE 2 - SIDE A

01:24:06 SEN. ELLIOTT said it is obvious that there is not much uniformity.

01:24:54 **Patrick Montalban, representing the Northern Montana Oil & Gas Association,** discussed Montana's current property valuation system, saying that his association thinks the current system is the best method and should be continued. Mr. Montalban said it is important to remember that it is very risky to build pipeline for natural gas wells because of the unpredictable nature of natural gas and that the gathering systems built in northern Montana have all been built exclusively from private funds and not subsidized by ratepayers. Because of those factors, these pipelines should not be centrally assessed.

01:30:52 SEN. ELLIOTT asked what right-of-way was used to build the privately funded pipelines. Mr. Montalban said that land was purchased from landowners, so private right-of-way was established.

- 01:33:24 Mr. Montalban discussed the price of natural gas and the recent decrease in price. He said that he believes it will decrease to approximately \$5 per MCF at the plant by the end of February 2006 and predicted that all energy commodity prices will come down.
- 01:34:16 Mr. Montalban explained the numerous gathering systems that were put in by independent producers, saying that the breakup of the Montana Power Company allowed the independent producers to purchase some of the smaller systems.
- 01:36:33 Mr. Montalban explained how operators with gathering systems in northern Montana pick up other producer's gas. He said that if the system is changed, the royalty owners, the state, and the producers will all be hurt and the opportunity for independent producers will be taken away.
- 01:38:22 SEN. ELLIOTT asked for an explanation of the economic arrangements for transporting gas from isolated wells. Mr. Montalban said that there are three main economic factors for gathering gas:
- the British Thermal Unit (BTU) adjustment;
 - the charge for running the gas through a compressor to transport it through the line; and
 - the gathering cost to recover the capital costs.
- Mr. Montalban said that these costs have to be negotiated with the person at the well head. Because the independent operators are using their own funding and are taking huge risks in building their own systems, the Committee ought to leave things as they are. The issue of oil flow lines is even more complicated and should also be left alone.
- 01:44:14 REP. LAKE pointed out, for clarification, that neither wells nor gathering lines are considered permanent structures. Mr. Montalban said that was true but pointed out that flow lines are usually left in place after a well has been plugged and abandoned. REP. LAKE said that there needs to be a way to distinguish between non-permanent lines (gathering lines) and long-term use lines (transmission lines) and whether the two types of lines should be valued differently. Mr. Montalban agreed with REP. LAKE's point and referenced SB 487, which was carried in the 1999 Legislature at the request of his association to address the issue of taxation of oil field equipment as personal property. Unfortunately, pipeline was not included in SB 487 and is the center of this issue. Independent producers create income that support schools, tax dollars for the state, and royalties for the owners, which proves the current process is working to the benefit of the state and ought not be changed.

Public Comment

- 01:49:57 **John Alke, MDU Resources**, responded to Mr. Montalban's comments and said it is clear that the independent producers are not being centrally assessed as MDU is, even though MDU is also a privately owned company and takes the same investment risks as the smaller independent companies. Mr. Montalban's testimony highlights the unfairness of the current assessment system, which is that MDU is one of three companies operating in Montana that are centrally

assessed, resulting in their tax rate being four times greater than locally assessed companies. The Department of Revenue should not be allowed to make the decisions on who should be taxed at what rates. This illegal discrimination is the reason for the HJR 44 study. The simple solution is to treat all producers the same.

01:55:18 REP. LAKE said it is his opinion that gathering is part of the production until it reaches the point of distribution. The Committee needs to clarify this description so that all companies may operate on the same level. He said that he didn't believe that overcharging businessmen such as Mr. Montalban will correct MDU's situation and that the independent companies are operating under the law as it was originally intended to be.

Mr. Alke said the point that must be addressed is that MDU's production facilities, owned by Fidelity Exploration and Production, and MDU's gathering and transmission companies, Bitter Creek and Williston Basin Pipeline, are all being centrally assessed. MDU has never challenged the central assessment of the gathering lines, only the production lines. MDU is focused on the issue of the central assessment of MDU's production facilities. He said he could not comment on whether gathering lines should or should not be centrally assessed because that is not an issue for MDU. **TAPE 2 - SIDE B** He said his personal opinion is that gathering lines should be locally assessed and that it would be easy to craft a definition and to legislate the definition. The difficulty faced in the 2005 session was in trying to solve both pieces of the puzzle because of the fiscal impact. REP. LAKE said Mr. Alke's comments clarifies even more the inequity in the tax structure.

02:00:16 **Dan Bucks, Director, Department Of Revenue (DOR)**, discussed the following points:

- this issue predates his appointment as Director and involves legislative decisions on classification, historic decisions about valuation methodologies, and how they apply in different circumstances;
- he has reviewed the cases and the decisions made by the professionals who preceded him;
- he takes great exception to Mr. Alke's comments regarding the professionalism and judgement of the Department;
- there are no personal decisions being made in the valuation of property and that no favoritism is shown;
- criteria for the valuation of property is clear; and
- DOR staff is professional, dedicated, ethical, and honorable.

02:02:56 **Gene Walborn, DOR**, briefly explained the process of valuation and emphasized that personal decisions or favoritism are not used by the Department in determining who is centrally assessed. The Committee has heard a great deal of discussion about the amounts invested by ENCORE and the independent companies but central assessment is not based on the amount a company invests in Montana. DOR continually monitors who is centrally assessed and who is locally assessed and has toured many facilities. However, some of the independent companies have denied DOR access to their production equipment

and it is difficult to determine valuation if information is denied. Both ENCORE and Mr. Montalban's company have been easy to work with but that is not the case with all producers.

Mr. Walborn said it is his opinion that the Committee is not the proper forum for hearing the court case. The DOR has identified the policy issues that it feels are of importance to property assessment and believes that the Committee is the appropriate venue in which to address those issues.

02:09:01 Mr. Montalban asked to clarify his comments regarding his company's investment in infrastructure. He said that Montana Power Company's improvements were often subsidized by the Montana ratepayers through the guaranteed 7% return. The independent companies do not get that guarantee. His systems are all located within one county but there are some operators that do cross county lines. The concern of the Northern Montana Oil & Gas Association is that wells will be lost because of central assessment.

Update on Omimex v. Department of Revenue

02:21:26 **Lee Heiman, Staff Attorney, LSD**, reviewed District Court Judge Jeffrey Sherlock's order denying motions for summary judgment that was issued January 17, 2006. Judge Sherlock determined that Omimex owns five properties that were all the former Montana Power Company and that the gas from those properties is being shipped to a single customer using three separate transmission lines, including one that crosses into Canada. Judge Sherlock was unsure how the transmission lines fit in the five different properties and requested additional information about how the system operates. Judge Sherlock said that he wanted a hearing in order to question witnesses and review exhibits. Judge Sherlock also requested additional information on how properties pass over county lines, discussed the issues relating to unitary assessment, and said that splitting of the property into centrally assessed and locally assessed parcels may be a possibility.

02:27:00 REP. MCALPIN asked if the commerce clause claim in the Omimex case is similar to the Kansas decision discussed by Mr. Martin in his report ([EXHIBIT #34](#)). Mr. Heiman said that it appears from the order that Omimex originally made a commerce clause claim but then failed to proceed with it, so Omimex basically lost it by default. There was apparently no argument on the commerce clause claim and since there was no argument, it was dismissed. REP. MCALPIN asked if the claim was dismissed with prejudice and could not be brought up again. Mr. Heiman said that he assumed that, if the factual situation turned out differently than what is started with, that the complaint could be amended and the commerce clause could probably be brought back.

02:28:05 SEN. ELLIOTT asked if there are companies that are centrally assessed but that own property that is not centrally assessed. Mr. Heiman said the central assessment should be on all of the operating equipment of the company. SEN. ELLIOTT said that it is either all or nothing. Mr. Heiman said that is the way he understands it.

- 02:29:03 Mr. Walborn agreed, and said that all of a company's property is valued but non-operating property is then is backed out. He discussed an example of a railroad that has vacant land that is not needed for the operation of the railroad and said the land would be backed out.
- 02:29:31 SEN. ELLIOTT gave the scenario of three different pipe line systems, all belonging to the same company and each of which cross county lines but are not connected to one another, except through a common carrier in Canada. He asked if each of the pipelines would be separately centrally assessed. Mr. Walborn said in the example given, if one company owns three systems and the pipeline crosses a county line, the three systems will be valued as a unit and be centrally assessed. SEN. ELLIOTT asked for clarification that the pipelines would be centrally assessed, even though the pipelines did not connect anywhere in the United States. Mr. Walborn said that is correct, providing the unit meets the criteria for central assessment.
- 02:31:14 Mr. Martin suggested that the Committee members occasionally read court cases regarding this issue because that would help them to gain a better understanding of tax policy and how courts handle these types of cases. Mr. Martin explained that the Kansas case (as discussed in [EXHIBIT #2](#)), has a detailed analysis of the different tests a court uses to determine if the commerce clause has been violated.
- Mr. Martin said that CIG Field Services protested the tax, both on commerce clause issues and on federal and state equal protection issues. It won on the commerce clause but the court dismissed the equal protection part.

Report on Meeting of Interested Parties - Proposals for Taxation of Oil & Gas Property

- 02:35:13 Mr. Martin said that he has discussed with the Department of Revenue the development of a database that would help evaluate potential fiscal impacts or changes that would occur as a result of this study. A meeting has been held between the interested persons to develop ideas. The DOR explained its proposal, as previously presented to the RTIC and the Senate Tax Committee in the 2005 legislative session, on determining what property should be centrally assessed. Industry representatives are also formulating ideas and the parties are hoping for a final product in mid-March for review. Discussion will continue and topics such as to what extent central assessment should be part of the classification system, if there is a market structure within which Omimex or Fidelity is operating, and revenue neutrality.
- 02:39:45 SEN. ELLIOTT said that the revenue effect on the local taxing jurisdictions is the most important point to consider and that previous legislation promising to reimburse local governments for tax cuts has not always occurred.

LEGISLATION TO ENABLE SHARING OF INFORMATION BETWEEN DOR AND LFD

- 02:41:32 SEN. ELLIOTT suggested that the Committee request a bill draft to provide for sharing of information and data between the DOR and the Legislative Fiscal Division, as well as other governmental agencies. He also suggested that the Committee allow the Legislative Finance Committee, the Office of Budget and

Program Planning, and the Legislative Fiscal Division to participate and be included as requesters. REP. COHENOUR **moved** to have the Revenue and Transportation Interim Committee request a bill draft to deal with the issue of data sharing between agencies.

02:42:43 REP. LAKE asked if there would be specific parameters placed on the bill draft. SEN. ELLIOTT said that the request would be left open at this point. The motion **passed on a unanimous voice vote.**

Department of Revenue Tours

02:43:35 SEN. ELLIOTT said that it would be difficult to arrange a time for the entire Committee to take a tour of the Department of Revenue and asked Director Bucks if arrangements could be made for small group or individual tours. **TAPE 3 - SIDE A** Director Bucks said he would prefer small groups but would work with the Committee. He said that DOR staff would explain the appraisal process, the significance of the work, and what the impact is on the taxpayer. He said that a security clearance would be required and that he would provide assistance in obtaining the clearance.

02:48:32 SEN. ELLIOTT asked that invitations be sent out to individual Committee members before the April RTIC meeting so that members could take a tour without incurring additional travel expenses. Director Bucks said he would do that and that the Department would schedule additional tours to coincide with the summer and fall RTIC meetings, in the event they are unable to take a tour in April.

02:50:32 SEN. ELLIOTT asked if the members wished to have an explanation of the appraisal process given at the next meeting. Mr. Martin said that the next Revenue and Transportation Committee meeting is scheduled for Friday, April 28, 2006. He said that the Committee has already used approximately 38% of its budget and that he is looking at why the Committee is so far ahead of its spending schedule. He said the budget may impact the remaining meeting schedule.

02:53:05 SEN. ELLIOTT asked for a report of agenda items for the April 28 meeting. Mr. Martin said that April agenda items include the HJR 44 study, the Department of Transportation/Highway 2 update as requested by SEN. KITZENBERG, and possibly a discussion of the reappraisal process, which may also include the Agriculture Advisory Committee.

ADJOURNMENT

02:54:37 With no further business before the Committee, SEN. ELLIOTT adjourned the meeting at 10:56 a.m. The next meeting of the Revenue and Transportation Interim Committee will be held on April 28, 2006, in Helena.