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An Alternative Approach to Cyclical Reappraisal To Promote Simplicity and Administrative Efficiency, and Enhance Taxpayer Understanding and Equity in Montana Property Taxation

Presented in Response to a Request for Information from the Revenue and Transportation Interim Committee

Montana Department of Revenue
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Executive Summary

At the April 29, 2010 meeting of the Revenue and Transportation Interim Committee (RTIC) members asked the Department of Revenue to report on the feasibility of moving to an annual approach to revaluation of property currently subject to cyclical reappraisal, as an option to replace the current law 6-year reappraisal cycle. This report is the Department's response to that request, and is anticipated to be the first of two reports on this topic. A second report, anticipated in September 2010, will address specific administrative processes and costs together with fiscal and policy impacts, as well as funding options.

Previous reports – including an independent report presented by Mr. Robert Gloudemans, a distinguished appraisal expert – have established that the market values set by the Department of Revenue for residential property meet the vertical and horizontal equity standards of the International Association of Assessing Officers (IAAO). In responding to this RTIC request the Department has applied those same tests to the market value data as modified by the legislated practices of using a multi-year cycle and a phase-in of the increases in value. The result of that statistical analysis is that the modified values produced by these two practices fall significantly outside the acceptable range of the IAAO statistical standards of equity in property valuation.

Research indicates that, in general, property tax systems become increasingly less equitable the longer the time between reappraisals, the faster the property values increase over time, and most importantly the greater the difference in the rate of growth in market values of properties across different regions of the state.

Table ES1 shows the actual tax year 2008 variation in the amount of property taxes paid per $1,000 of true market value (sales prices) for the fixed, statewide 101-mill levy for the general fund and the university system for properties whose values have increased by varying rates of growth. This table includes all residential lots with improvements. As the table shows, homes whose values have increase the slowest paid $2.03 per $1,000 of market value at the end of the reappraisal cycle, which is more than double the amount paid by homes whose values grew the fastest ($0.72 per $1,000 of market value).

Table ES1

Actual Taxes Paid per $1,000 of True Market Value By Decile Group (Based on % Change in Market Value) Tax Year 2008 (Final Year of 2003 Reappraisal Cycle)

Decile Group	Number of Properties	% Change in MV TY2002 - TY2008	Taxes Paid per $1,000 of True MV
1	39,754	<10%	$2.03
2	39,754	10% - 24%	$1.71
3	39,754	24% - 34%	$1.55
4	39,754	34% - 42%	$1.45
5	39,754	42% - 50%	$1.37
6	39,754	50% - 58%	$1.30
7	39,754	58% - 67%	$1.24
8	39,754	67% - 80%	$1.16
9	39,754	80% - 106%	$1.05
10	39,754	>106%	$0.72
	Statewide median value:		**$1.32**
	Coefficient of dispersion (COD):		**26**

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Introduction

The recently completed 2009 reappraisal of property for tax purposes resulted in statewide *average* increases in values for improved residential properties, commercial and industrial properties, agricultural land, and forest land of 55%, 34%, 29%, and 52%, respectively. Depending on location across the state, changes in value for individual properties could have been much higher or lower than these *average* increases.

These significant increases in value stem in large part from the current policy of revaluing properties subject to cyclical reappraisal just once every six years. In times of relatively rapid growth in market values many taxpayers, particularly homeowners, inevitably experience some degree of "sticker shock" when presented with their newly reappraised values for tax purposes. And in some cases, the resulting sudden growth in property tax liabilities can greatly outpace growth in taxpayers' incomes.

Some legislators have expressed concerns with a general disconnect between taxpayer perceptions of value and what properties are actually selling for. Even though two separate sales-assessment ratio studies have shown that appraised values for property for tax purposes relative to actual market values (selling prices) are well within general guidelines for reappraisal practices, this disconnect continues.

The lengthy time between revaluations is one factor that underlies the disconnect between the public's perception of value and the actual market. The prohibition on public disclosure of sales price information may also contribute to taxpayers not understanding the connection between actual market prices and the appraised values used for property tax purposes.

The current complex system of mitigating the impact of cyclical reappraisal also makes it more difficult for taxpayers to understand the property tax system. The mitigation measures—changing rates and exemptions and the incremental phase-in of increases in value—both substantively change and cloud the link between appraised values and final property tax liabilities.

In addition to these concerns, the current system of reappraisal does not appear to comport with equity standards adopted by the International Association of Assessing Officers, and may further be perceived as being inequitable because some properties are reappraised just once every six years while many other properties are reappraised every year. Properties reappraised every year are paying property taxes based on their full market value in each year, but certain properties subject to cyclical reappraisal (certain Class 4 residential and commercial properties, e.g.) never pay property taxes based on their full market value.

Finally, while arguably less significant than the issues of taxpayer understanding and tax equity, the complexity of the current tax system decreases the efficiency of and increases the costs to the public of the administration of the property tax system.

In addressing these concerns policy makers have raised the possibility of moving away from the current 6-year cycle approach to an alternative approach that would provide for annual revaluation of property values. In response to a request from the Revenue and Transportation Interim Committee, this document provides a discussion of the implications involved in revising the current reappraisal cycle by moving to an annual revaluation cycle. Following sections will provide:

- the legislative history and background of how Montana has arrived at its current approach to the reappraisal process;
- how different approaches to reappraisal impact taxpayer equity;
- a brief overview of the current and proposed administrative approaches to reappraisal; and
- a brief discussion of the more recent issues involving reappraisal and the courts, and how the discussed approach will meet current legal requirements.

A subsequent paper anticipated for the September meeting of the Revenue and Transportation Interim Committee will provide further discussions of selected policy and fiscal implications, and a more detailed discussion pertaining to administration of an annual approach to reappraisal, the costs associated with such an approach, and alternative means of funding those costs.

History and Background

Montana's Constitution (Article VIII, Section 3) provides that: *"The state shall appraise, assess, and equalize the valuation of all property which is to be taxed in the manner provided by law."* The intent of this section is further clarified in state statute (MCA, 15-8-111(1), which provides that: *"All taxable property must be assessed at 100% of its market value except as otherwise provided."*

The constitutional requirement makes Montana somewhat unique in that we are one of just two states (Maryland being the other state) where administration of the property tax is vested centrally with the state. Nearly all states vest the appraisal, assessment and other property tax functions with local governments, with oversight and equalization of the valuation process carried out by state agencies.

Regarding the statutory market value standard, certain mine property is taxed based on either the net or gross proceeds from the mineral being mined, agricultural and forest land are taxed based on their productivity value, while all other property subject to taxation is taxed based on its market value.

Currently, there are 14 separate classes into which different types of property subject to taxation may be classified. State statute specifically provides that all property is to be revalued annually except for Class 3 agricultural lands, Class 4 residential, commercial and industrial properties, and Class 10 forest lands, which are all subject to cyclical (periodic) reappraisal (MCA, 15-7-111(1).

Table 1 provides a summary of appraisal periods and valuation standards by current property classes.

Table 1

Current Property Classes, Appraisal Periods and Valuation Basis

Property Class	Description	Appraisal Period	Valuation Basis
1	Mines net proceeds	Annual	Net Proceeds
2	Metal mines gross proceeds	Annual	Gross Proceeds
3	Agricultural land	Cyclical	Productivity Value
4R	Residential property	Cyclical	Market Value
4C	Commercial/industrial property	Cyclical	Market Value
5	Pollution control, coops	Annual	Market Value
7	Rural elec. coops	Annual	Market Value
8	Business equipment	Annual	Market Value
9	Elec. utilities dist. and pipelines	Annual	Market Value
10	Forest land	Cyclical	Productivity Value
12	Railroads/airlines	Annual	Market Value
13	Telecom and elec. generation	Annual	Market Value
14	Renewable energy (wind)/biomass	Annual	Market Value
15	CO2 pipelines/carbon sequestration	Annual	Market Value
16	High-voltage DC converters	Annual	Market Value

Regarding property subject to cyclical reappraisal, Montana is today at the beginning of its 7th reappraisal cycle since adoption of the 1972 Constitution, which created the Department of Revenue and provided for central administration of the property tax. With some variation, these 7 reappraisal cycles have, on average, lasted 6 years.

Since 1990, growth in the market value of residential property has averaged 9.7%, annually. To be sure, some of this growth stems from new construction; but a very large share of this growth stems from growth in the value of existing properties as well. For the 1997, 2003, and 2009 reappraisal cycles, the market value of *existing* residential property was estimated to have grown 40%; 20%; and 55%, respectively.[1] Simply allowing reappraised market values to take effect at the end of each cycle would result in extremely large increases in the amount of property taxes paid by residential property taxpayers, and would also shift a large portion of the total tax bill away from other property types onto residential properties. Hence, the Montana Legislature has acted to offset or mitigate the effects of increases in market values stemming from reappraisal on homeowners, commercial properties, agricultural land, and forest land in each of the past reappraisal cycles.

In earlier reappraisal cycles, the Legislature simply reduced the taxable valuation rate applied to all Class 4 properties commensurate with the increase in valuation to provide for taxable-value-neutrality statewide. In the 2nd reappraisal cycle (1978), the taxable valuation rate was reduced from 12% to 8.55% in response to an overall increase in Class 4 (residential and commercial) market value of 47%. The taxable valuation rate was again reduced from 8.55% to 3.86% for the 3rd cycle (1986) in response to an overall increase in market value of over 120%.

[1] Corresponding increases in the market value of commercial properties for these cycles were 24%, 19%, and 34%, respectively.

For the 4th cycle (1993), reappraisal increased Class 4 market values by just 7%, so the Legislature opted to make no adjustments to address this minor increase in average value. This increase was extremely low because the 1987 Legislature had earlier required annual sales-assessment ratio adjustments to Class 4 properties in each year from 1988 through 1992. Although the Montana Supreme Court ultimately found these annual adjustments to be unconstitutional (*Montana Department of Revenue v. Sheehy*), the adjusted values were allowed to remain on the books for administrative purposes.

For the 5th cycle (1997), the 1999 Legislature initiated the mitigation approach that has generally been in effect for the past three cycles, including the current cycle, which includes the following major elements, generally designed to maintain taxable-value-neutrality for Class 4 as a whole:

- *increases* in the market value of Class 4 residential and commercial properties are phased in in equal increments over the course of the next cycle;
- the taxable valuation rate is phased down over the next cycle; and
- "homestead" and "comstead" exemptions are phased up over the following cycle.

The 1999 Legislature also initiated the homestead and comstead exemptions, which provided that a percentage of the market value of residential and commercial properties would be exempt from taxation (SB184, 1999). The 1999 Legislature also for the first time provided for phasing in any *increase* in the market value of residential and commercial properties over the course of the next reappraisal cycle.[2] But because the Montana Supreme Court found (in *Roosevelt v. Montana Department of Revenue*) phasing down decreases in market value to be unconstitutional, the 1999 Legislature also provided that any *decrease* in market value arising from reappraisal would take effect immediately in the first year of the new appraisal cycle.

This general approach to mitigating the impacts of reappraisal was continued in the 6th reappraisal cycle (SB461, 2003), but with a new program feature. Concerned that mitigation efforts that mitigated to the average increase in value failed to address cases where extraordinary valuation increases could result in large tax increases for certain low income households, the 2003 Legislature augmented previous mitigation efforts by adding the Extended Property Tax Assistance Program (EPTAP).

For the 7th cycle, the 2009 Legislature continued the general approach to mitigating the impacts from reappraisal used during the previous two cycles, but added new features by providing that the homestead exemption applies only to the first $1.5 million of

[2] This was not the first instance of phasing in changes in value following reappraisal, however. The first instance occurred during the 4th reappraisal cycle when the 1993 Legislature phased in the change in reappraised values for agricultural land *only,* beginning January 1, 1994. Both increases and decreases in valuation were phased in over a four-year period. In addition, because new values for agricultural land were established during this cycle for the first time since 1962, the legislation mitigating the impacts on ag land also provided for a reduction in the taxable valuation rate from 30% to 3.86%, and has since tied the taxable valuation rate for ag land to the rate applied to Class 4 property (SB168, 1993).

market value of the "dwelling" portion of residential properties, and requiring that sales/assessment ratio studies be conducted every two years during the current reappraisal cycle (HB658, 2009).

Table 2 provides a summary of the changes in Class 3, 4, and 10 taxable valuation rates, and the homestead and comstead exemption percentages, over the course of the past three reappraisal cycles. As the table shows, the taxable valuation rate applied to both Class 3 agricultural land and Class 4 residential, commercial and industrial properties has declined from 3.84% in 1997 to 2.47% by 2014 under current law. The homestead exemption – the percent of full market value excluded from taxation – has increased from 16% to 47%, and the comstead exemption has increased from 6.5% to 21.5%. These changes have acted to reduce the effective taxable valuation rate on residential property by 66%, on commercial property by 50%, and on agricultural land by 36% over this time frame. The taxable valuation rate on Class 10 forestland has been reduced from 0.79% in 1997 to 0.29% by 2014, which represents a 63% reduction in this tax rate over this period.

Table 2

Changes in Class 3, 4, and 10 Taxable Valuation Rates and Homestead and Comstead Exemption Amounts

	Tax Year	Class 3/4 TV Rate	Homestead Exemption	Comstead Exemption	Class 10 TV Rate
5th Reappraisal cycle	1997	3.84%	n.a.	n.a.	0.79%
	1998	3.82%	n.a.	n.a.	0.79%
	1999	3.71%	16.0%	6.5%	0.68%
	2000	3.63%	23.0%	9.0%	0.57%
	2001	3.55%	27.5%	11.0%	0.46%
	2002	3.46%	31.0%	13.0%	0.35%
6th Reappraisal cycle	2003	3.40%	31.0%	13.0%	0.35%
	2004	3.30%	31.4%	13.3%	0.35%
	2005	3.22%	32.0%	13.8%	0.35%
	2006	3.14%	32.6%	14.2%	0.35%
	2007	3.07%	33.2%	14.6%	0.35%
	2008	3.01%	34.0%	15.0%	0.35%
7th Reappraisal cycle	2009	2.93%	36.8%	14.2%	0.34%
	2010	2.82%	39.5%	15.9%	0.33%
	2011	2.72%	41.8%	17.5%	0.32%
	2012	2.63%	44.0%	19.0%	0.31%
	2013	2.54%	45.5%	20.3%	0.30%
	2014	2.47%	47.0%	21.5%	0.29%

Equity Considerations

Different approaches to reappraisal can impact equity among property taxpayers substantially. This section examines the equity implications of three alternative approaches to reappraisal of residential properties: the approach adopted by the Legislature prior to the current approach, the current approach to reappraisal, and the alternative annual approach to revaluation being considered here.

In examining equity implications, this section of the paper will reference the standard measures of assessment equity as adopted by the International Association of Assessing Officers (IAAO), the widely recognized authority in this regard. In particular, this section will refer to the *assessment level*, which is the median (or average) ratio of assessed value to true market value (or sales price), and the *coefficient of dispersion* (COD), which is a statistic that summarizes the variability in the assessment ratios of

different properties.[3] Assessment level is generally recognized as a measure of vertical equity (the degree to which all properties are on average appraised at their true market value), while the COD is generally recognized as a measure of uniformity or horizontal equity (the degree to which similarly situated properties are treated similarly).

Ideally, equity in taxation, as suggested by the Montana Constitution, is achieved when all residential properties are taxed at all times based on their true market value. While the ideal is rarely if ever fully attainable, different approaches to reappraisal can move a tax system closer to or further away from the ideal.

Previous Montana Reappraisal System

Prior to the present day approach to reappraisal, Montana used to appraise all Class 4 property on a cyclical basis, with market values implemented fully in the first year of a cycle, accompanied by an immediate reduction in the taxable valuation rate to maintain taxable value neutrality in the first year of the new cycle.

Table E1 provides a hypothetical illustration of this approach by showing the change in market value for twelve representative properties from across the state over the course of a 6-year reappraisal cycle; the assessed value of these properties, which remains constant over the course of the cycle; and the rate of growth in market value for each property over the cycle. The average rate of growth of all properties is 55%. However, some properties represent market areas where growth is much faster than the average; some represent market areas where growth is similar to the average, while other properties represent market areas where growth is lower than the average, including properties where growth is negative.

This example was developed specifically to reflect the observed heterogeneous market dynamics of residential properties in Montana.

The bottom portion of the table shows how the standard equity indicators discussed above change as market values change each year in relation to assessed values over the course of the cycle. In the first year of the cycle, assessed values for tax purposes are very close to the actual true market value of each property. The median assessed to market value ratio of 1.01 coupled with a very low COD of 2.36 indicate a very high degree of equity in appraisal.

Recall that IAAO standards recommend a level of appraisal that lies between 0.90 and 1.10, while the COD for newer and fairly homogeneous areas should be 10.0 or less, but in no case larger than 15.0.

[3] IAAO ratio study standards indicate that for residential property the appraisal level should lie between 0.90 and 1.10, while the COD should be 10.0 or less for newer and fairly homogeneous areas, but no larger than 15.0 in general.

Table E1

Previous Reappraisal System - Property Assessed at Full Market Value in Year 1
No Phase In, No Change in Effective Taxable Valuation Rate Over the Cycle

Property	Year 1 Assessed Value	Market Value Each Year of Reappraisal Cycle						Growth Rate
		1	2	3	4	5	6	
1	345,000	340,000	408,000	476,000	544,000	612,000	680,000	100%
2	222,000	215,000	249,400	283,800	318,200	352,600	387,000	80%
3	172,000	176,000	204,160	232,320	260,480	288,640	316,800	80%
4	269,000	280,000	316,400	352,800	389,200	425,600	462,000	65%
5	183,000	175,000	194,250	213,500	232,750	252,000	271,250	55%
6	156,000	154,000	170,940	187,880	204,820	221,760	238,700	55%
7	287,000	295,000	336,300	377,600	418,900	460,200	501,500	70%
8	186,000	180,000	194,400	208,800	223,200	237,600	252,000	40%
9	164,000	165,000	161,700	158,400	155,100	151,800	148,500	-10%
10	171,000	176,000	179,520	183,040	186,560	190,080	193,600	10%
11	108,000	105,000	103,950	102,900	101,850	100,800	99,750	-5%
12	97,000	95,000	95,000	95,000	95,000	95,000	95,000	0%
Totals	2,360,000	2,356,000	2,614,020	2,872,040	3,130,060	3,388,080	3,646,100	55%

Equity Indicators (Assessed Value to Market Value Ratios)						
Median	1.01	0.93	0.84	0.77	0.71	0.66
C.O.D.	2.36	6.57	11.73	16.63	21.37	26.00

Over the cycle, as market values generally grow, but at significantly different rates of growth, the median ratio of assessed value to market value drops to 0.66 and the COD increases to 26, indicating a very low degree of equity in appraisal by the sixth year of the cycle.

The erosion in vertical equity, as measured by the drop in the median ratio of assessed to market value, is simply attributable to the fact that market values, on average, have increased over time. On the other hand, the erosion in horizontal equity, as measured by the increase in the COD from 2.36 in the first year to 26.00 in the sixth year, is attributable to the fact that market values grew by widely divergent rates, depending on location across the state. Had every property's market value grown by the average rate of 55%, the median ratio in the sixth year would still be 0.66, but the COD would have remained at 2.36, indicating a drop in vertical equity but no erosion in horizontal equity. Given the wide diversity in Montana's economic, cultural and scenic landscape it is no surprise that market dynamics statewide more closely parallel those depicted in Table E1, rather than more homogeneous growth patterns.

Using the same hypothetical examples shown in Table E1, Table E2 illustrates the *tax* inequities that arise under this approach to reappraisal. This table shows the total tax liability associated with the fixed, statewide 101-mill levy for the general fund and the

university system, and tax liability per $1,000 of true market value in year 1 and year 6 of the reappraisal cycle.[4]

In year 1, taxes paid per $1,000 of true market value are tightly grouped around the median value of $1.34; all properties pay very similar amounts of tax. By year 6, however, there is a wide dispersion in taxes per $1,000 of true market value around the median value of $0.88; and the COD of 26.00 suggests large inequities in the amount of tax paid across different properties.[5]

The final column in the table shows the percentage change in the amount paid per $1,000 of market value. The higher the growth rate in true market value over the course of the cycle (see Table E1), the larger the percentage reduction in taxes paid per $1,000 of market value in year 6 of the cycle.

Table E2

Taxes per $1,000 of True Market Value (101 State Mills)
Year 1 and Year 6 of Reappraisal Cycle, and % Change

Property	Tax Liab. All Years	Tax per $1,000 of True MV		% Change
		Year 1	Year 6	
1	$456.16	$1.34	$0.67	-50%
2	$293.53	$1.37	$0.76	-44%
3	$227.42	$1.29	$0.72	-44%
4	$355.67	$1.27	$0.77	-39%
5	$241.96	$1.38	$0.89	-35%
6	$206.26	$1.34	$0.86	-35%
7	$379.47	$1.29	$0.76	-41%
8	$245.93	$1.37	$0.98	-29%
9	$216.84	$1.31	$1.46	11%
10	$226.09	$1.28	$1.17	-9%
11	$142.80	$1.36	$1.43	5%
12	$128.25	$1.35	$1.35	0%
	Median	$1.34	$0.88	
	C.O.D.	2.36	26.00	

Regarding this approach to cyclical reappraisal we can conclude that:

- *Given general, overall growth in market values at widely varying rates across the state, equity in appraisal is likely to erode in each year of a reappraisal cycle, with equity continuing to erode the longer the cycle, and the more divergent the growth rates in various regions of the state.*

- *Nevertheless, in the one year each cycle where assessed values approximate market values there is a high degree of equity in appraisal.*

- *The faster the market value of a property grows, the greater the percentage reduction in tax liability per $1,000 of true market value by the end of the cycle.*

- *Moving to full reappraisal values in the first year of the cycle can result in significant sticker shock for many taxpayers, as evidenced by the spike in property taxpayer appeals of valuations in the first year of each 6-year cycle.*

[4] These calculations assume that the effective taxable valuation rate remains constant at 1.31% – the actual rate for the final year of the current cycle (TY2014) – over the course of the cycle. Note that the CODs for both years would not change regardless of which taxable valuation rate is used.

[5] Note that when the tax rate is constant for all properties variability in taxes paid per $1,000 of true market value as measured by the COD is equal to the variability in the ratio of appraised to market value in each year of the cycle. (See the COD for years 1 and 6 in Chart E1.)

Current Montana Reappraisal System

The previous reappraisal system provided for full implementation of market values in the first year of each reappraisal cycle. Assuming that assessed values approximated actual market values, this resulted in equitable appraisal in the first year of the cycle, with equity eroding as the cycle wore on as illustrated above. Equity considerations aside, implementing market value in full in the first year resulted in major sticker shock for many taxpayers whose values had increased substantially over the course of the previous cycle.

To address the potential for sticker shock, the Legislature adopted the current approach to reappraisal. That is, any *increase* in market value is phased in in equal increments over the course of the succeeding cycle, and *effective* taxable valuation rates are phased down in each year over the cycle to maintain taxable value neutrality statewide.[6]

How do these changes affect equity?

Note, first, that under the current system of reappraisal the equity relationship between *assessed value* and *true market value* is the same as that shown in Table E1 for the previous reappraisal system. Hence, all of the inequities that arise over the course of the reappraisal cycle under the previous system *with respect to these two values* also occur under the current system.

The current system, however, adds an additional layer of complexity. Rather than implementing full market value immediately in the first year of the cycle, any increases in market value are phased in in equal increments over the course of the 6-year cycle. Hence, property *taxes* are not based on full market value, but on the phase-in value in any year of the cycle, including year 1.

Continuing with the examples from Table E1, Table E3 illustrates the variability in taxes paid per $1,000 of true market value in year 1 of the reappraisal cycle for the state 101 mills under the current approach to reappraisal.

In this example, assessed value (Column 3) is the same as in Table E1. In addition, Table E3 also shows for each property the value before reappraisal (VBR – Column 2), which was the assessed value from the previous reappraisal cycle. Column 4 shows the rate of growth in assessed value from the previous cycle to the current cycle. These growth patterns are similar to those in Table E1 in that they again reflect the heterogeneous market dynamics characteristic in Montana.[7]

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[6] Effective taxable valuation rates take into consideration homestead (or comstead) exemptions as well as the statutory taxable valuation rate.

[7] The overall growth rate of 21% is very close to the actual growth rate of 20.2% for the 2003 reappraisal.

Column 5 shows the phase-in value which, relative to the previous approach to reappraisal, replaces full market value as the basis for taxation. The sixth column shows total taxes paid to the 101 state mills; and the final column shows taxes paid per $1,000 of true market value.[8]

Under the current approach, the median tax paid per $1,000 of true market value is $1.65 and the variation around the mean is reflected in a COD of 9.67. Whereas under the previous approach to reappraisal, where full market values were implemented immediately, the COD in the first year was a very low 2.36, the COD under the current approach in year 1 increases to 9.67, which is nearly as high as the COD under the previous approach in year 3.

Table E3

Current Reappraisal System - Increases in Market Value Phased In
Variability in Taxes per $1,000 of True Market Value (State 101 Mills)

Property	VBR	Year 1 Assessed Value	Growth Rate	Year 1 Phase-In Value	Year 1 Taxes	Per $1,000 of True MV
1	241,000	345,000	43%	258,333	$483.16	$1.42
2	164,000	222,000	35%	173,667	$324.80	$1.51
3	128,000	172,000	34%	135,333	$253.11	$1.44
4	212,000	269,000	27%	221,500	$414.27	$1.48
5	151,000	183,000	21%	156,333	$292.39	$1.67
6	129,000	156,000	21%	133,500	$249.68	$1.62
7	221,000	287,000	30%	232,000	$433.90	$1.47
8	159,000	186,000	17%	163,500	$305.79	$1.70
9	174,000	164,000	-6%	164,000	$306.73	$1.86
10	168,000	171,000	2%	168,500	$315.14	$1.79
11	112,000	108,000	-4%	108,000	$201.99	$1.92
12	97,000	97,000	0%	97,000	$181.42	$1.91
Totals	1,956,000	2,360,000	21%			
				Median		$1.65
				C.O.D.		9.67

As has been demonstrated earlier, by the 6th year of a reappraisal cycle true market values vary significantly from assessed values being used for property tax purposes. This is particularly true when market values grow at substantially different rates from region to region, and results in very large CODs in the 6th year. Phasing in increases in market values at the beginning of a new cycle, rather than implementing and taxing based on full market values, acts to perpetuate large variations in assessed to market value ratios at the end of one cycle into the beginning of the next cycle, when looking at property taxes paid per $1,000 of true market value.

Therefore, regarding the current approach to cyclical reappraisal we can conclude that:

- *Given general, overall growth in market values at widely varying rates across the state, equity in appraisal is likely to erode in each year of a reappraisal cycle, with equity continuing to erode the longer the cycle.*

- *In contrast to the previous approach to reappraisal, phasing in increases in market values perpetuates the inequities inherent in the final year of the previous cycle precluding the likelihood of a high degree of equity in taxation in any year of the cycle (provided that growth dynamics remain relatively constant, for which proposition there is considerable evidence).*

[8] In this case, total taxes paid are based on the actual tax year 2009 taxable valuation rate and homestead exemption. True market value is the same as that shown in Chart E1.

- *The faster the market value of a property grows, the greater the percentage reduction in tax liability per $1,000 of true market value by the end of the cycle.*

- *Phasing in values may abate some of the sticker shock that otherwise might occur (though data for property taxpayer valuation appeals still indicate a major spike in the first year of the phased-in 6-year cycle), but does so at a loss of equity and simplicity.*

And furthermore:

- *The perpetuation of inequities from the end of one cycle to the beginning of another cycle under the current approach to reappraisal is not unlike the perpetuation of inequities found when applying a single sales/assessment ratio within an area to the value of all properties to improve the overall level of appraisal. The latter approach, which improves overall level of appraisal, does little to improve pre-existing problems with uniformity (horizontal inequity), and generally has not met favor with the courts.*

Table E4

Summary Comparison - Previous v. Current Reappraisal Approach
Percent of MV Subject to Tax, and C.O.D. of Taxes Paid per $1,000 of True Market Value

	Percent of MV Subject to Tax		C.O.D. of Taxes per $1,000 of True MV	
Year	No Phase-In	With Phase-In	No Phase-In	With Phase-In
1	100%	85%	2.36	9.67
2	90%	80%	6.57	13.65
3	82%	75%	11.73	17.16
4	75%	71%	16.63	20.34
5	70%	68%	21.37	23.27
6	65%	65%	26.00	26.00

Table E4 provides summary statistics comparing the previous (no phase-in) and current (with phase-in) approaches to reappraisal. Under the previous approach, 100% of market value is taxed in the first year of the reappraisal cycle, and the percent of market value subject to tax remains higher through the fifth year of the cycle relative to the current approach where increases in value are phased in over the cycle. In addition, the COD of taxes paid per $1,000 of true market value is lower in all years, except the final year, under the previous approach where increases in value are not phased in, relative to the current approach. Once again, while the current approach may act to alleviate some of the sticker shock associated with reappraisal, it does so at the expense of equity and simplicity in property taxation relative to the previous approach.

Regardless of the effect that phasing in increases in value has on equity vis-a-vis *tax payments*, the *market values* established by the Department of Revenue in the first year of all past appraisal cycles have been found to be equitable.

While the above discussions pertaining to the previous and current reappraisal cycles relied on hypothetical examples for expository purposes, *real world data bear out these conclusions.*

Alternate Annual Montana Reappraisal System

Under the alternative system discussed here, all properties would receive new assessed values each year. There would be no phasing in of values. To the extent that these assessed values closely approximate actual market values, as indicated by the results from carefully administered sales/assessment ratio studies, the issues related to equity inherent in both the previous and current reappraisal systems would disappear:

- *Revaluing properties annually would allow little to no time for true market values to diverge from assessed values precluding any erosion in appraisal equity.*
- *Because assessed values would approximate market values in all years, the system would be characterized by a high degree of equity in all years.*
- *Because property taxpayers would be paying taxes based on current market values there would be little variability in the amount of taxes paid per $1,000 of true market value across properties within jurisdictions where the tax rate is the same.*
- *Sticker shock would be limited greatly to just the increase in value from one year to the next, which may act to significantly reduce the number of informal appeals (AB26s) filed and the underlying taxpayer confusion.*

Reappraisal – Current Approach – Administration

Class 3 agricultural land, Class 4 residential and commercial properties, and Class 10 forestland are subject to *cyclical reappraisal*; all other taxable property in the state is reappraised annually. Currently, property subject to cyclical reappraisal is reappraised over the course of a 6-year cycle; that is, new reappraised values for these properties for property tax purposes are established just once every six years at the end of the reappraisal cycle.

The Department of Revenue's Property Assessment Division (PAD) is responsible for establishing reappraised values for all property subject to cyclical reappraisal.[9] This

[9] Reappraising properties subject to cyclical reappraisal is just one of many duties and tasks administered by PAD. To name a few, other duties and tasks carried out annually include certifying taxable valuations for virtually every taxing unit in the state (counties, cities and towns, school districts, etc.); administration related to *per capita* livestock fees and the state's hail insurance program; annual revaluation of all Class 8 business equipment; and administration of certain property tax circuit breaker programs such as the PTAP, EPTAP, and DAV programs.

requires establishing new values for over 900,000 parcels of property, with this number growing every year.

It is important to note that in the context of the current approach the term *reappraisal* incorporates the notion that, prior to a new appraised value being assigned, an effort is made to ensure that each and every property subject to cyclical appraisal is physically or otherwise inspected to ensure that both the external and internal physical characteristics of that property are accurately identified, documented and entered into the department's property tax computer databases.

The massive amount of information gathering that is needed, coupled with the labor-intensive and time-consuming nature of the reappraisal process, is reflected in the Legislatures' recognition that under the current approach a 6-year cycle is needed to ensure an adequate level of accuracy in establishing new values for property tax purposes.

Among the many critical functions and processes required for cyclical reappraisal are:

- Sales verification (annually)
- Discovering new construction (annually)
- Field inspections of taxable property (annually)
- Computer-assisted land price (CALP) modeling of land values (mid-cycle)
- Market modeling and benchmarking (mid-cycle)
- Cost collection, cost calculations, depreciation analyses, income and expense data collection and analyses, ECF calculations, etc. (end of cycle)
- Final determination of value (end of cycle)
- Administration and processing of informal reviews and formal protests of value (AB26 process, CTAB, and STAB; following each cycle).

Reappraisal – Alternate Approach and Administration

Under the "annual" approach to reappraisal contemplated here each property currently subject to *cyclical reappraisal* would be given a new appraised value every year. However, every property would not be "physically" examined every year, as such an undertaking would be prohibitively expensive; neither is it necessary (see the section on Legal Considerations).

Instead, under an annual approach, all properties in the state currently subject to cyclical appraisal would continue to be physically inspected at least once every six years, while all properties, whether physically inspected or not, would have their values adjusted using standard market modeling, income, and cost methods. This would follow similar approaches already in use in taxing jurisdictions outside Montana, Idaho being one example.

Because the process of physically appraising property would continue under a 6-year cycle, many of the functions, processes, and activities of the PAD would continue as they do today. Implementing annual revaluation would, however, require additional resources not currently available.

The department's objective when considering how best to effectively administer a system of annual revaluation would not simply focus on how to get "more resources" but would instead focus on how to become "more efficient"; that is, how to get the job done at minimal cost through increased productivity. In essence, this means acquiring new technology and the specific staff required to effectively utilize this technology, and obtaining the information critical to an annual revaluation process. All three elements – technology, staffing, and information – would be essential to the successful transition to an annual revaluation process.

Technology

Annual revaluation would be greatly aided through the use of *oblique imagery* (aerial photography) and the required associated software (change detection software). Oblique imagery technology provides an efficient and effective way of detecting changes to the perimeters of existing structures and finding new construction. This would require at least two flyovers prior to implementing annual revaluation, preferably two years apart. Oblique imagery is currently being used in 48 states. Statewide coverage would likely be prohibitively expensive, so the department would at this time recommend using this technology to image the 12 counties with the largest concentrations of population and property.

Additional efficiencies would be obtained by providing staff with *field computers and wireless Internet access*. Time spent in the field would become substantially more productive as the wireless Internet access software would allow staff to utilize the oblique imagery to locate properties known to have changed, collect the data on those properties and input the information directly into the system on site, as opposed to having to capture the data on paper first and then input the data after returning to the office. This would also reduce the possibility of errors.

All aspects of effectively and efficiently administering a process of annual revaluation will depend on the ability of the Department's *Orion* property tax computer system to perform up to expectations. On one hand, eliminating the phase in of increases in property values will reduce significantly the number of calculations required to revalue property, freeing up processing time and storage space. On the other hand, new requirements associated with more intensive market and income modeling, coupled with the requirement to provide annual assessments will require new computer resources that may more than offset the benefits accruing from annual reappraisal.

Information Requirements

Oblique imagery, coupled with field inspections, will greatly aide department staff in identifying changes to the exterior boundaries of structures, but may not provide information pertaining to changes on the inside of structures. A program of *self-reporting* by taxpayers may enhance the ability to identify changes associated with the interior of structures. The Department is currently in the process of exploring how best to go about implementing a program of property tax self-reporting that may be a much simpler version of the income tax return process.

Sales verification is the life blood of the market modeling process. Because annual revaluation, to be successful, will require a significant expansion of the market and income modeling process it is equally important that there be comprehensive and timely verification of real estate sales to support these essential functions.

Currently, the Department mails new assessment notices to all taxpayers subject to cyclical appraisal at the end of the 6-year cycle, and notices just those taxpayers with changes to property in the interim years. Under annual revaluation the Department would be required to provide annual assessment notifications to all property owners every year. This will significantly increase computer processing time, and printing and mailing expenses on an annual basis, but it keeps property taxpayers more informed.

Staffing

Annual reappraisal would require additional staffing in those areas most critical to an annual process. While the Department is still evaluating exactly where additional staff would be needed, it is clear at this time that at a minimum additional staffing would be required in the areas of market and income modeling, and in computer assisted land pricing (CALP) modeling; additional GIS cartographers would greatly facilitate annual reappraisal of ag and forest lands.

Agricultural and Forest Land

It is unlikely that the Department of Revenue has ever been better positioned to undertake annual reappraisal of agricultural and forest land. Given the comprehensive nature of the 2009 reappraisal of these property types, the annual reappraisal of ag and forest land should become a matter of formulaic valuation.

The central administrative issue regarding annual reappraisal of these properties will be largely limited to determining annual changes in land use (classification). Implementing a new program of self-reporting of land use changes by producers, not unlike the current self-reporting of business equipment by producers, would aide significantly in this process. This, along with the addition of new GIS cartographers coupled with a capable GIS interface with the Orion system, would likely secure the ability to complete annual reappraisal of agricultural and forest land well into the future.

Additional Administrative Considerations

There are two additional administrative considerations raised by RTIC that would facilitate not only annual revaluation, but also potentially benefit the current reappraisal process. The first of these is to change the law to provide for full disclosure of sales prices of properties. The second consideration is to require the submission of valid income and costs statements prior to being able to appeal the value of commercial properties. The Revenue and Transportation Interim Committee is currently in the process of considering both of these provisions of law, and these topics will be addressed in separate papers.

Quality Assurance

Increasing the frequency of reappraisal is of little value if the quality of reappraisal is compromised. In this regard, it would behoove policymakers to consider an ongoing program of quality assurance characterized by periodic sales/assessment ratio studies to gauge the quality of annual revaluations. These studies could be conducted using existing department resources, or by contracting externally with professional consultants (in the same manner as provided for in HB658 of the 2009 session), which would require additional funding.

Timing

Allowing the current law 6-year reappraisal cycle to run its course prior to implementing annual revaluation would provide the opportunity to carefully consider all aspects of annual revaluation, and increase the likelihood of a smooth transition to the new system.

First, it is unlikely that the Department would be able to implement annual reappraisal sooner without incurring substantial additional administrative costs above those that would be required if the current cycle were allowed to run its course. Allowing the current cycle to run its course would also provide the Department with the time needed to consider all aspects of moving to annual reappraisal, develop the underlying computer systems and programming needed to accommodate that approach, provide for the two flyovers needed to begin using oblique imagery, and develop the professional staff needed to conduct the market and other modeling required of annual revaluation.

Second, allowing the current cycle to run its course will afford the Legislature ample time to contemplate the policy and fiscal implications of annual revaluation and debate and decide the most appropriate response.

Third, allowing the current cycle to run its course will not result in additional major expenditures for at least a few years, at which time, hopefully, the state will be better positioned financially to accommodate the additional expenditures required to shift to annual reappraisal.

Under this scenario, new valuations from the current cycle would take effect for tax year 2015, with the first valuations from annual revaluation taking effect for tax year 2016.

Legal Considerations

Previous sections of this report have touched on some of the legal issues to consider when addressing annual revaluation of properties currently subject to cyclical reappraisal. In particular, the section on history and background briefly touched on the Montana Supreme Court's finding that the stratified sales/assessment ratio study approach to adjusting values annually "...offends state constitutional principles", and the section on equity considerations suggested that the current approach to reappraisal may be open to challenges on similar grounds. This section of the report discusses these and other legal considerations involved in moving from cyclical reappraisal to annual revaluation of property.

This is not the first time the Montana Legislature has contemplated annual revaluation of Class 4 properties. The 1985 Legislature, anticipating extraordinary increases in the market value of Class 4 property to be implemented January 1, 1986, provided that the taxable valuation rate applied to all Class 4 property was to be reduced in a manner that would maintain taxable value neutrality statewide. When in 1986 the Director of the Department of Revenue certified an average increase in the market value of all Class 4 property in excess of 120%, the taxable valuation rate was reduced from 8.55% to 3.86% to offset the increase. Nevertheless, the extremely large increases in the market values of these properties, many of which greatly exceeded the average of over 120%, resulted in major sticker shock for many taxpayers.

Hoping to avoid the sticker shock that inevitably arises at the end of extended reappraisal cycles, the 1987 Legislature passed HB436 which provided that the Department of Revenue was to conduct annual sales/assessment ratio studies for the express purpose of determining appropriate assessment *levels* within designated appraisal areas throughout the state. If the sales/assessment ratio study indicated a ratio outside the range of 0.95 to 1.05 then the market values of all properties within the designated study area were adjusted by a single factor to bring the ratio to 1.

First, in Department of Revenue v. Barron (1990), and then in Department of Revenue v. Sheehy (1993), the Montana Supreme Court found this approach to valuation to violate the equal protection and due process clauses of both the United States and Montana Constitutions. In short, the Court found that even though this approach acted to improve the level of assessment (vertical equity), it did nothing to address any pre-existing inequities stemming from wide variation in ratio values (horizontal inequities) that existed prior to applying a single adjustment factor to all properties. In other words, this approach did not resolve, but instead continued, any egregious inequities generally measured using the distributional statistic referred to earlier as the coefficient of dispersion (or COD).

Indeed, in reaching its decisions in both *Barron* and *Sheehy*, the Court appears to have relied on a fundamental, underlying legal dictum holding that where it is impossible to secure both the standard of true value (assessment level, or vertical equity) of a taxpayer's property and the uniformity and equality in taxation required by law (distributional equity, or horizontal equity), then the latter is to be preferred as the just and ultimate purpose of the law (Department of Revenue v. State Tax Appeal Board, 1980).

Given previous Court findings, the current system of reappraisal, wherein tax liability is based not on market value but on phase-in value, and where end-of-cycle horizontal inequities (high COD values) are perpetuated into the succeeding cycle, again because of the use of phase-in values rather than market values, would on its face appear to be susceptible to fairness challenges addressing both level and uniformity.

On the other hand, the alternative approach to annual revaluation described here should meet with Court approval. Under this approach new values are not established by applying a single sales/assessment ratio factor to all properties, but by annually revaluing properties using time-tested and court-approved methods of value modeling that incorporate the market, cost, and income approaches.

Annual revaluation of this nature appears to meet all tests of fairness and equal treatment required of a constitutional system. For example, one could argue that it is encompassed by the Court's approval of the 5-year cyclical reappraisal system in *Patterson v. State*, 557 P.2d 798 (1976):

> *Where, as here, a uniform rule is provided for statewide application to determine the reappraisal rotation, the type and amount of property to be reappraised in each year in each county there is no violation of uniformity requirements.*
>
> *It must be recognized that in any cyclical revaluation plan temporary disparities within the cycle between individual property valuations both within the county and between counties are inevitable. Nonetheless such cyclical plans have been uniformly upheld against uniformity and equal protection attacks under state and federal constitutional provisions in the absence of intentional, systematic, arbitrary or fraudulent discrimination.*

In addition, *DOR v.Barron,* 799 P.2d 533 (1990); *DOR v. Sheehy,* 862 P.2d 1181 (1993); and *Roosevelt v. DOR*, 975 P. 2d 295 (1999); are all easily distinguishable. The values determined under the proposal are immediately phased in (both up and down) and they are determined by an appraisal process, not a ratio process.

Furthermore, using a combination of market, income and cost approaches was found to satisfy constitutional requirements in *Albright v. State of Montana*, 281 Mont. 196, 933, P.2d 815 (1997).

As discussed earlier, while all properties would receive a new value each year, not all properties would be physically inspected each year, but all properties would be physically inspected over the course of a 6-year cycle. While visitation clearly is mostly preferable and may be a measure of the quality of assessment, the varied approaches to appraising different properties would suggest that physical inspection is not a required element of an annual appraisal process. For example:

- MCA 15-7-139(6) explicitly provides a procedure for valuation by estimation when the property owner will not permit access;

- agricultural and timber assessment can be accomplished with satellite or other overhead imagery and information from federal soil productivity data to a level that physical inspection would not improve; and

- physical inspection of property that is assessed as a unit under Title 15, Chapter 23 of the Montana Code, would be exceptional.

Other examples arise where inspection is highly impractical, including properties in remote wilderness areas accessible only by plane or boats. These types of properties may be inspected aerially as the only realistic alternative.

All of this is permitted by the Uniform Standards of Professional Appraisal Practice under provisions that permit disclaiming physical inspection, or provisions that allow jurisdictional exceptions (i.e., compliance with local law):

"Comment: Scope of work includes, but is not limited to: the extent to which the property is identified; *the extent to which tangible property is inspected . .* ;" (emphasis added.)

"JURISDICTIONAL EXCEPTION RULE: If any part of USPAP is contrary to the law or public policy of any jurisdiction, only that part shall be void and of no force or effect in that jurisdiction."

Appendix A, prepared January, 2009 for the Senate Taxation Committee by the previous and current code commissioners (Greg Petesch and Lee Heiman), provides a comprehensive summary of the main constitutional property tax parameters that in general lend support to the legal conclusions arrived at here.

Summary

This report, presented at the request of the Revenue and Transportation Interim Committee (RTIC, April, 2010) has attempted to provide policymakers with the history, equity considerations, and legal basis for the existing and prior cyclical reappraisal processes. Given property taxpayer reactions to the 2009 reappraisal and the apparent complexities of the process, the RTIC asked the Department to discuss the potential for

a one-year or annual revaluation process to replace the present law 6-year cyclical reappraisal process.

In a subsequent report, anticipated for the September 2010 RTIC meeting, the Department will develop the administrative requirement in more detail, and project the fiscal impacts and potential funding options for an annual revaluation approach.

An Alternative Approach to Cyclical Reappraisal To Promote Simplicity and Administrative Efficiency, and Enhance Taxpayer Understanding and Equity in Montana Property Taxation
Part 2 of 2

Presented in Response to a Request for Information from the Revenue and Transportation Interim Committee

Montana Department of Revenue
Larry Finch, Tax Policy and Research
Presented by Alan Peura, Deputy Director

September 2010

INTRODUCTION

At the April 29, 2010 meeting of the Revenue and Transportation Interim Committee (RTIC) members asked the Department of Revenue to report on the feasibility of moving to an annual approach to revaluation of property currently subject to cyclical reappraisal, as an option to replace the current law 6-year reappraisal cycle. This report continues the Department's response to that request, and is the second of two reports on this topic.

The first report, presented August 3, 2010, covered the history and background of reappraisal in Montana, equity considerations associated with the previous and current approaches to reappraisal, the general administrative changes needed to implement annual revaluations, and some of the legal considerations involved in reappraisal.

Some of the concerns and reasons that have been discussed by the Revenue and Transportation Interim Committee for moving to annual revaluations in lieu of the current 6-year reappraisal process include the following:

- Waiting six years to provide taxpayers, particularly homeowners, with updated market values during periods of relatively rapid growth inevitably results in a high degree of "sticker shock" for many taxpayers.
    - *In some cases the resulting sudden growth in property tax liabilities stemming from new appraisals can outpace growth in taxpayers' incomes.*
    - *Many taxpayers experience a general disconnect between individual perceptions of value and what properties may actually be selling for.*
- The current highly complex system used to mitigate the impact of cyclical reappraisal – which includes phasing in increases in value, gradual reductions in taxable valuation rates, and gradual increases in homestead and comstead exemptions – makes it very difficult for taxpayers to understand the property tax system, and clouds the link between appraised values and final property tax liabilities.
    - *The complexity of the current system also significantly decreases the efficiency of and increases the costs to the public of the administration of the property tax system*
- The current approach to reappraisal raises serious concerns with respect to equity among different taxpayers and different taxpayer groups, particularly among homeowners.
    - *Regarding the relationship between assessed values for tax purposes and true market values of residential properties, waiting six years to re-establish assessed values inevitably results in a continual decrease in the ratio of*

assessed to market value (level of reappraisal) and a continual increase in the dispersion of these values from the median (uniformity in reappraisal) resulting in equity measures far outside the standards established by the International Association of Assessing Officers (IAAO).

- *This erosion in equity standards is more pronounced the longer the period between reappraisals, the faster that property values grow over time, and the more divergent the rates of growth in property values across different regions of the state.*

- *Because property values grow at widely divergent rates across the state the amount of taxes being paid per $1,000 of true market value under the current approach varies significantly from property to property, with faster growing properties paying a significantly smaller amount of taxes per $1,000 of value than properties whose values have grown slowly or declined.*

- *The current feature of phasing in increases in market values at the beginning of each reappraisal cycle acts to exacerbate equity concerns as this approach acts to perpetuate the inequities inherent in the final year of the previous cycle.*

- *Many taxpayers may perceive the current system to be inequitable because properties that are reappraised every year (e.g., electric and telecom utility property, business equipment, railroad and airline property) pay taxes based on their full market value every year whereas certain properties subject to cyclical reappraisal (e.g., certain residential and commercial properties) may never pay property taxes based on their full market value.*

- *Fixing reappraisal values for six years does not allow valuation to track the housing market; values used to determine tax liabilities (phase-in values) could be increasing at the same time that market values are decreasing.*

In addressing these concerns, policymakers have raised the possibility of moving away from the current 6-year reappraisal cycle approach to an alternative approach that would provide for annual revaluation of property values. This document provides a discussion of selected administrative impacts and other issues involved in revising the current reappraisal cycle by moving to an annual revaluation cycle. Following sections will provide:

- a discussion of the changes in administrative practices required to accomplish annual revaluation of property;
- the anticipated cost of each of the new administrative requirements over the course of the next several years;
- a discussion of possible ways of funding additional administrative expenses; and
- a final section will raise a policy concern that will have to be addressed by policymakers if annual revaluation is adopted.

ANNUAL REVALUATION – ADMINISTRATION

This section discusses the changes in administrative practices required to effectively and efficiently implement a program of annual *revaluation* of properties currently subject to *reappraisal* under a six-year cycle (class 3 agricultural land, class 4 residential and commercial properties, and class 10 forest land). The information in this section is based on the following assumptions:

- *Under the annual approach to revaluation contemplated here, all properties in the state currently subject to cyclical appraisal would continue to be physically inspected at least once every six years, while all properties, whether physically inspected or not, would have their values adjusted annually using standard market modeling, income, and cost methods.*

- *The current six-year reappraisal cycle would be allowed to run its course with new assessed values from the current cycle taking effect for tax year 2015, and with the valuations from the annual revaluation approach taking effect first for tax year 2016.*

Continuing an underlying six-year cycle of physical inspection to provide an accurate documentation and recording of property characteristics vital to accurate valuations would allow many of the functions, processes, and activities carried out by the property assessment division to continue as they do today. On the other hand, annual revaluation would require acquiring and deploying new technology, adding the specific staff needed to effectively utilize this technology, and obtaining the information critical to the process. The separate elements essential to this approach were discussed in the paper presented in August and at a minimum include:

Technology

- Oblique imagery (aerial photography), and the associated software used to detect changes in the external characteristics of real property, referred to as "change detection software"
- Field computers for field staff coupled with wireless Internet access
- A highly effective and efficiently functioning Orion computer system
- A capable and effective GIS interface with the Orion system

Information Needs

- A comprehensive system for property taxpayers to report changes in the characteristics of residential real property, and changes in agricultural land use
- Accurate, timely, and reliable sales verification data in quantities sufficient to ensure statistical accuracy in market modeling
- Increased computer processing time, coupled with added printing and mailing costs, to produce annual assessment notices
- Contracting with a reputable firm that would provide commercial valuation information and modeling software

Staffing

- Additional staff to ensure an adequate volume of data related to sales verification
- Additional staff to carry out substantially increased activities in the areas of market, income, and computer assisted land price (CALP) modeling
- Additional GIS cartographers to ensure an accurate and efficient valuation of agricultural and forest land

In addition, the Legislature may also wish to consider having the department contract with consultants to verify the accuracy of annual revaluations through annual or biennial sales/assessment ratio studies.

Allowing the current six-year cycle to run its course prior to implementation of annual revaluations also allows the additional expenditures associated with annual revaluation to be spread over several years, rather than all at once. At this time, the department estimates the additional annual expenditures needed to transition to annual revaluations to be as follows:

FY2012:	$0
FY2013:	$739,945
FY2014:	$1,925,120
FY2015:	$1,431,190
FY2016:	$2,277,690

Details of the types of expenditures required, when the expenditures would be occur, and the estimated costs associated with each expenditure are provided in Appendix A.

ADMINISTRATIVE COST FUNDING OPTIONS

There are several potential means of funding the above costs associated with moving to annual revaluation. The first option is that the Legislature simply provides the department with an appropriation that covers total operating expenses of the department, including the additional costs associated with annual revaluation, while maintaining vacancy savings rates similar to historic rates or rates applied to other state agencies. This would require an expansion in the number of FTE working in the department.

A second option would exempt the Property Assessment Division from vacancy savings and pay for some, if not all, additional administrative expenses associated with a requirement for new FTE by utilizing all current positions authorized. This would result in fewer authorized new FTE, and future vacancy savings rates could be analyzed based on the actual performance in completing annual revaluations.

A third option would consider implementing an additional statewide mill levy in 2016 to fund the on-going incremental costs associated with annual revaluation. The levy would be applied to all taxable property in the state with a separate account created for deposit of the revenue from the levy. Appropriations would be spent from revenue in the account.

A fourth option would be to share the cost of the incremental expenses with other agencies or governmental units that would be provided access to the information generated from the oblique imagery technology and other data maintained for revaluation purposes. For example, experience in other states has shown that oblique imagery is of significant value to governmental and other agencies involved in law enforcement, emergency preparedness and response, fire departments and rural fire management agencies, and medical treatment facilities. Local governments may also benefit significantly from oblique imagery and other valuation data as they contemplate growth policies, the expansion of government infrastructure, the creation or consolidation of school districts, and annexation proposals. Authorizing local governments to levy for this purpose would maintain autonomy in local decision making while mitigating the need for statewide funding options.

A fifth option may be to provide the information obtained from oblique imagery and other revaluation efforts to private sector companies for a fee. Private sector industries that may be interested in purchasing this type of information include lending institutions, realty firms, and titling companies.

Finally, a sixth option would include some combination of the above five funding options.

ANNUAL REVALUATION – FISCAL AND POLICY CONSIDERATIONS

Montana's property tax system is highly complex. Major changes in property tax policy, such as moving from cyclical reappraisal to annual revaluations, can affect different types of property and different taxpayers in different ways. This section provides a discussion of some of the fiscal and policy implications inherent in moving away from cyclical to annual revaluation, and assumes the above discussed timeline for moving to annual revaluation. That is, the current six-year reappraisal cycle will be allowed to run its course with new values from the current cycle taking effect January 1, 2015 and with new values from annual revaluation first taking effect January 1, 2016.

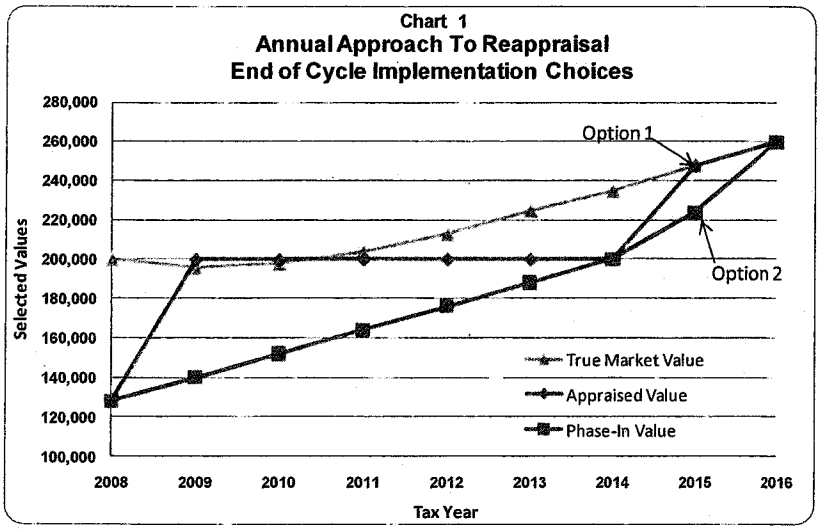
Short-Term Policy Implications

Notwithstanding the fact that the overall market for residential properties in Montana has grown slowly during the first couple of years of the current cycle, it is likely that more normal growth patterns in coming years will once again result in significant increases in

reappraised values at the end of the current cycle (tax year 2014).[1] For the past three cycles the tax effects associated with these increases in reappraised values have been mitigated by gradually reducing the taxable valuation rate, gradually increasing the homestead exemption, and phasing in increases in reappraisal values over the course of the subsequent six-year cycle. Since this policy prescription would no longer be applicable, the first policy consideration involves how to go about making the transition from the current cyclical approach to reappraisal to annual revaluations at the end of the current cycle. More specifically, adopting an annual approach to revaluation will require a determination of how new reappraisal (market) values should be converted to taxable values for state and local property tax purposes during the transition period following the end of the current reappraisal cycle until the annual revaluations begin.

Chart 1 illustrates the time path of the different property values involved in making the transition from cyclical reappraisal to annual revaluation.[2] In Chart 1, the green line (triangles) represents the true market value of property over the current six-year reappraisal cycle. In this particular example, true market value dips slightly in 2009, and is assumed to recover slightly in 2010 before resuming more historic growth rates throughout the remainder of the period. The blue line (diamonds) represents the full appraised value of property before the phase-in adjustment. This value increases from $128,000 in 2008 to $200,000 in 2009, which represents the average change in market value due to the latest reappraisal (55%), and remains at $200,000 for the duration of the current cycle. The red line (squares) represents the phase-in value of property over the current reappraisal cycle, with the difference between $128,000 and $200,000 phased-in in equal increments over a six-year period.

At the end of the current reappraisal cycle, the Department of Revenue will establish new appraised values for all residential properties and put those values on the books on January 1, 2015. In the above example, the appraised value increases from $200,000 in 2014 to $248,000 (true market value) in 2015.



[1] While the discussion here focuses on residential property, the concepts and implications carry over to commercial, agricultural and forest land properties as well.

[2] The values in Chart 1 are for expository purposes only and can be used to represent the values associated with a single piece of property, or the total value of all residential property in a region expressed in $millions.

At this point (tax year 2015), policymakers have several policy options. First, new appraised values could simply be allowed to go on the books in full with no change in any other policy parameters such as the taxable valuation rate or homestead exemption. Given the limitations on growth in local government property taxes provided for at MCA, 15-10-420, and given the manner in which school mill levies are established, *this jump in value would not result in an increase in revenue to these governmental units, but would result in a shift in the total tax bill away from all other classes of property to residential property.* Absent other changes, however, this increase in value would result in a measurable increase in revenue to the state general fund and to the university system account because the 95-mill levy for the state general fund and the 6-mill levy for the university system are fixed in law and not allowed to "float" for changes of this nature. Policymakers in 2015 would need to judge whether the tax shifting and revenue increase associated with this approach are acceptable or not.

Alternatively, new values could be allowed to go on the books in full, but the taxable valuation rate and/or the homestead exemption applied to residential properties could be adjusted to fully offset the average increase in value.[3] Complicating this option is the fact that under current law the taxable valuation rate applied to agricultural land is defined as the rate that is applied to residential property. If policymakers were to find at the end of the current reappraisal cycle that no change in the taxable valuation rate applied to agricultural land is warranted, then the offset needed to maintain taxable value neutrality for residential property could still be achieved by adjusting the homestead exemption only.[4] For example, given the tax year 2014 current law taxable valuation rate of 2.47% and homestead exemption of 47.0%, the increase in value in Chart 1 from $200,000 in 2014 to $248,000 in 2015 would be fully offset by increasing the homestead exemption to 57.3%.

Under this approach there would be no net statewide increase in revenue to local governments, school districts, or state accounts from residential properties. To the extent that the market value of property in classes other than residential property increases in tax year 2015, and absent any change in the taxable valuation rates of these other classes, there would be a shift in the share of the total tax bill away from residential property to these other classes of property, relative to the shares paid by each class in tax year 2014.

Both of the above alternatives contemplate moving to full reappraisal value in tax year 2015 as indicated by the Option 1 arrow in Chart 1. However, in moving from tax year 2014 values to tax year 2016 values, at which point by definition all properties would be appraised as closely as possible at full market value, policymakers have the option of

[3] This is the same approach to mitigating the impacts of reappraisal that was taken in early reappraisal cycles. See the previous report on the impacts of moving to annual revaluation presented at the August 3 meeting of the Revenue and Transportation Interim Committee for a full discussion of the history and background of reappraisal cycles and tax impact mitigation approaches since 1972.

[4] Policymakers may find that implementing an annual approach to revaluation may be facilitated by legislation that includes decoupling the Class 3 taxable valuation rate from the Class 4 rate

phasing in valuation increases in tax year 2015, as designated by the Option 2 arrow in Chart 1. In other words, instead of implementing full reappraisal (market) values in tax year 2015 policymakers could base taxes on values that are, say, half way between the tax year 2014 appraisal values and tax year 2015 full reappraisal (market) values. As with Option 1, adjustments to the taxable valuation rate and/or the homestead exemption could still provide for statewide taxable value neutrality.

At this time it is difficult to say what the relative advantages or disadvantages may be with respect to the two options discussed above, as the benefits of one or the other may depend on the state of the housing market in Montana at the time these decisions ultimately would be made. Nevertheless, if we assume that housing values will be increasing at the end of the current cycle in a scenario similar to that depicted in Chart 1, some differences in the two options can be discussed.

Implementing full reappraisal value in 2015 (Option 1) would eliminate any equity concerns from that point forward, and may simplify computer requirements and otherwise facilitate administration of the shift to annual revaluation. On the other hand, allowing the new 2015 reappraised values to be phased in would continue equity concerns for an additional year and may complicate administration, but may act to reduce taxpayer reaction to the valuation changes.

Long-Term Policy Considerations

Under the current cyclical reappraisal system appraised values are updated once every six years. Given historic growth in valuation this has meant that once every six years property taxpayers, particularly homeowners, face a sudden, substantial, and highly visible increase in their appraised values for tax purposes. To mitigate the tax impacts of these large increases in value the Legislature has provided for phasing in any increases in appraised value over the subsequent six-year cycle. In addition, the taxable valuation rates applied to cyclically appraised properties have been gradually decreased, and the homestead and comstead exemptions applied to residential and commercial properties have been gradually increased over the subsequent six-year cycle as well.

Under a system of annual revaluation, the phase-in element of the current system becomes moot as values are updated annually. However, if at the end of the current reappraisal cycle a system of annual revaluation is adopted the Legislature will have to decide whether to continue with annual reductions in taxable valuation rates and/or increases in homestead and comstead exemptions to offset any annual increases in the market or productivity values of residential, commercial, agricultural land, and forest land properties.

All other things remaining equal, reducing the taxable valuation rate for any class of property (or increasing homestead and comstead exemptions) acts to shift a portion of the total tax bill away from that class of property to the remaining classes of property.

Since 1995, some notable examples of reductions in taxable valuation rates that have acted to shift property taxes to other classes of property include the following:

- The taxable valuation rate on Class 8 business equipment has been reduced from 9% to 3%;
- The taxable valuation rate for centrally-assessed telecommunications and certain electrical generation property has been reduced from 12% to 6%;
- As a result of other taxable valuation rate reductions, the taxable valuation rate for Class 12 railroads and airlines has been reduced from 7.31% to 3.45% (2009).[5]

In addition, at the end of the current reappraisal cycle, the Legislature will have been systematically shifting property taxes away from the cyclically appraised properties to all other classes of property for a period of at least 18 years as well. This shift arises as a consequence of the decreases in taxable valuation rates and the increases in homestead and comstead exemptions that have occurred over the course of the past three reappraisal cycles. These adjustments have resulted in the following rate reductions:

- The taxable valuation rate for agricultural land has been reduced from 30% to 2.82% (2010);
- The taxable valuation rate on Class 10 timberland has been reduced from 4% to 0.33% (2010);
- The effective taxable valuation rate on Class 4 residential property has been reduced from 3.86% to 1.71% (2010); and
- The effective taxable valuation rate on Class 4 commercial property has been reduced from 3.86% to 2.37% (2010).

In the long term, policy makers have at least three policy options to choose from regarding annual revaluations:

First, policymakers could continue the long-term policy of providing annual reductions in the effective taxable valuation rate applied to properties subject to cyclical reappraisal (residential, commercial, agricultural and forest), while keeping the taxable valuation rates of all other classes of property constant. This option will continue to shift the tax base and property taxes away from these properties to all other classes of property.

Second, policymakers could allow annual revaluation of residential, commercial, agricultural and forest properties to occur without making adjustments to tax rates and exemptions, allowing the portion of the tax base associated with these properties to grow in tandem with market and productivity values.

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[5] The reduction in the Class 12 tax rate for railroads and airlines is an indirect consequence of legislative actions affecting the taxable valuation rates of other classes of property in that the federal 4R's Act requires that the taxable valuation rate applied to railroad property can be no higher than the statewide average rate applied to all "commercial" property.

Third, policymakers could adopt the second approach above, but couple it with a circuit-breaker program targeted to homeowners most in need of relief.

Given these considerations, the Legislature may wish to consider (regardless of whether annual revaluations are adopted or not) an interim study designed to examine the current state of property taxation in Montana and the implications of tax shifting as a consequence of reductions in tax rates for selected classes of property, and specifically provide for the underlying rationale for policy prescriptions that contemplate changes in tax rates. In moving from the six-year reappraisal cycle to annual revaluations, this will be a primary policy for consideration and the ultimate decision will determine how tax rates and exemptions would be addressed going forward.

SUMMARY

This report has been prepared and provided at the request of the Revenue and Transportation Interim Committee in an attempt to define, explain, and project the cost of an alternative to the current law six-year reappraisal cycle. None of the above is intended to be a Department of Revenue recommendation, but rather an idea and model for consideration.

APPENDIX A

Appendix A

Annual Revaluation - Timeline of Estimated Expenditures
(FY2013 - FY2016)

FY	Expenditure Item	FTE	Expenditure Amount OTO	On-Going	Total
2012	**No Expenditures Anticipated in FY2012**				**$0**
2013	Valuation Modeling Software and Maintenance		$38,000	$82,000	$120,000
	Market Modelers	4	$20,980	$226,600	$247,580
	Field Appraisers	7	$36,715	$335,650	$372,365
	FY 2013 Expenditures (Above FY2010 Base)	**11**	**$95,695**	**$644,250**	**$739,945**
2014	Oblique Imagery - Flyover (Fall of 2013)		$0	$420,500	$420,500
	Oblique Imagery - Annual Maintenance		$0	$5,000	$5,000
	Valuation Modeling Software and Maintenance		$0	$82,000	$82,000
	Market Modelers	9	$26,225	$509,850	$536,075
	GIS Cartographers	2	$10,490	$103,040	$113,530
	Field Appraisers	14	$36,715	$671,300	$708,015
	Contract - Forest Land Costs		$0	$60,000	$60,000
	FY 2014 Expenditures (Above FY2010 Base)	**25**	**$73,430**	**$1,851,690**	**$1,925,120**
2015	Oblique Imagery - Annual Maintenance		$0	$5,000	$5,000
	Valuation Modeling Software and Maintenance		$0	$82,000	$82,000
	Orion system conversion to annual approach		$60,000	$0	$60,000
	Market Modelers	9	$0	$509,850	$509,850
	GIS Cartographers	2	$0	$103,040	$103,040
	Field Appraisers	14	$0	$671,300	$671,300
	FY 2015 Expenditures (Above FY2010 Base)	**25**	**$60,000**	**$1,371,190**	**$1,431,190**
2016	Printing/Mailing Assessment Notices		$0	$320,000	$320,000
	Oblique Imagery - Flyover (Fall of 2015)		$0	$420,500	$420,500
	Oblique Imagery - Annual Maintenance		$0	$5,000	$5,000
	Oblique Imagery - Change Detection Software		$0	$106,000	$106,000
	Valuation Modeling Software and Maintenance		$0	$82,000	$82,000
	Market Modelers	9	$0	$509,850	$509,850
	GIS Cartographers	2	$0	$103,040	$103,040
	Field Appraisers	14	$0	$671,300	$671,300
	Contract - Forest Land Costs		$0	$60,000	$60,000
	FY 2016 Expenditures (Above FY2010 Base)	**25**	**$0**	**$2,277,690**	**$2,277,690**

2013 Biennium Total Expenditures:	**$739,945**
2015 Biennium Total Expenditures:	**$3,356,310**
2017 Biennium Total Expenditures:	**$4,555,380**

***Note:** The above expenditure estimates are based on current (FY2010) costs and do not take into account any increases in costs that may arise as a result of inflation or legislatively provided pay increases.*