SENATE TAXATION
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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
Part 2 of 2

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

Montana Department of Revenue
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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.

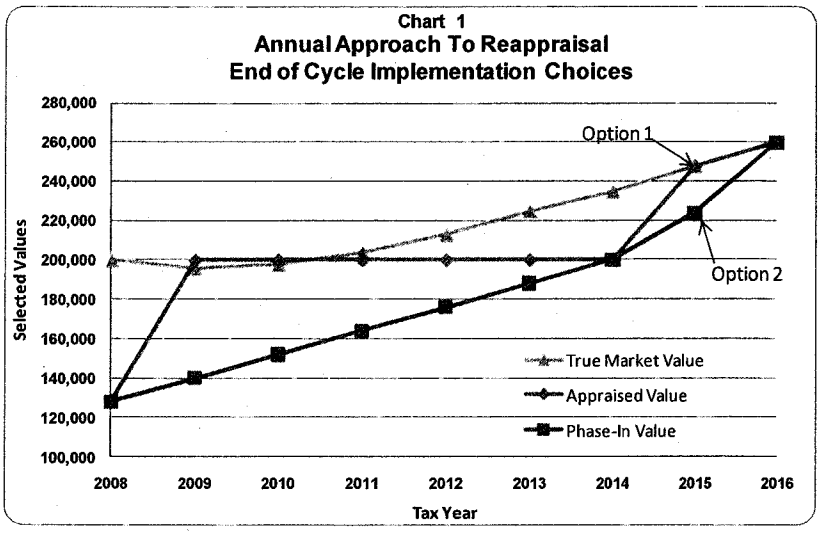
Short-Term Policy Implications

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

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[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.

[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.*