



Montana Department of Revenue

Mike Kadas
Director



Steve Bullock
Governor

DATE 4-12-13
HB 38398

To: House Taxation Committee

From: Dan Whyte, Senior Tax Counsel

Re: Senate Bill No. 398
Legal Analysis of *Covenant Investments, Inc. v. State* and *Lucas, et al., v. DOR*

Date: April 12, 2013

Constitutional and Statutory Obligations

The Montana Constitution, Article VIII, § 3, requires equalization of values of property:

The state shall **appraise, assess, and equalize the valuation of all property** which is to be taxed in the manner provided by law.

Article VIII, § 4, Mont. Const., requires coordination with all taxing jurisdictions:

All taxing jurisdictions shall use the assessed valuation of property established by the state.

This is supported by statute, pursuant to § 15-9-101(1), MCA:

The department shall **adjust and equalize the valuation of taxable property** among the several counties, between the different classes of taxable property in any county and in the several counties, and between individual taxpayers and **shall do all things necessary to secure a fair, just, and equitable valuation of all taxable property** among counties, between the different classes of property, and between individual taxpayers.

Covenant Investments, Inc. v. State

The Montana Eighteenth Judicial District Court has recently determined that the Department of Revenue's six-year reappraisal cycle for appraising class four properties is unconstitutional as applied.

- DOR appraised Covenant's properties as part of the six-year reappraisal cycle beginning 2008 and ending 2014.

- Covenant appealed the initial valuation of its properties, which were revised by the DOR. The revised appraisal was not appealed.
- However, in 2009 and 2010 Covenant argued its property values had declined significantly from the 2008 valuation and that it was being taxed on a value that exceeded the actual fair market value of the properties and therefore was paying a disproportionate share of the state's tax burden.
- Covenant argued that a mid-cycle review of its property was necessary.
- The District Court agreed, determining:
 - Covenant was receiving disparate treatment because the reappraisal statute (15-7-111) caused it to bear a disproportionate share of Montana's tax burden; and
 - As applied, the statute was unconstitutional by failing to provide for a mid-cycle reappraisal of Covenant's property.

Referring to the Supreme Court decisions in *Roosevelt v. Department of Revenue* and *Department of Revenue v. Barron*:

... taxing a Montana residential property owner on a value that exceeds the actual market value of the property is constitutionally impermissible.

The *Covenant* Court ultimately found:

... the failure to provide for mid-cycle reappraisals within § 15-7-111, MCA, can violate a residential property taxpayer's equal protection rights by causing that taxpayer to bear a disproportionate share of Montana's tax burden by taxing on an overstated property value, while taxing other Montana taxpayers based on fair or understated values.

Covenant is on appeal to the Montana Supreme Court. If upheld, its effect on the current six-year reappraisal cycle is significant:

1. The six-year cycle, as applied, is unconstitutional because it fails to consider changes in market value during the 5 years after the year of valuation. This alone would require a statutory restructuring of the six-year reappraisal cycle.
2. Changes in the market will necessitate a mid-cycle review of properties requiring a reappraisal of properties.
 - a. The Montana Code Annotated currently does not provide a vehicle for a mid-cycle review of individual properties or of classes of properties;
 - b. A mid-cycle review will raise additional questions as to which properties and which classes should or should not be reappraised;
 - c. A full mass reappraisal may be required, at a substantial cost; and

d. A mid-cycle review will also open the gates to additional appeals of the mid-cycle revaluation.

Lucas, et al., v. DOR

For the 2009 reappraisal cycle, the DOR was charged with performing a comprehensive review of agricultural properties. Because of the phase-in requirements, full reappraisal value is not achieved until the end of the cycle. To determine the amount subject to phase in, the DOR reduced the 2008 productivity value of the property by the property's value before reappraisal ("VBR"). The DOR then phased in the difference between these values over the course of the six-year cycle at a rate of 16.66% each year.

Example: The DOR would reduce the property's 2008 productivity value of \$50,000 by its VBR of \$47,000, and phase in the \$3,000 difference at a rate of \$500 per year. Thus, taxes would be calculated based upon a productivity value of \$47,500 during the first year, \$48,000 the second year, and so on, until the taxes were based on the full productivity value of \$50,000 in the sixth year.

The Department considered two different VBRs depending on changes that occurred to an agricultural property.

(1) If it was determined that no change had been made to the property or that any change had occurred strictly as a result of market forces outside the control of the property owner, the 2003 value was used. An example of market forces includes changes to the commodity price.

(2) If there was an increase in value resulting from land use changes or productivity (nonmarket) changes, physical changes within the control of the property owner, the DOR calculated the VBR as of the date of the 2008 cycle. Examples of land use changes include, land splits, improvement grade changes, or land reclassifications.

In 2012, Lucas (a rancher), Montana Taxpayers Association, and the Montana Farm Bureau Federation sued the DOR, arguing that the Department should not have been allowed to calculate the VBR and instead the 2003 productivity value of agricultural property must be used as the VBR for all phase-in calculations.

The plaintiffs have requested certification of a class action for all similarly situated agricultural owners and have requested attorney fees and costs.

Requiring a two-year cycle in statute will eliminate a law suits driven by issues as to the correct VBR and issues related to the phase-in.