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## MEMORANDUM

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**DATE:** December 12, 2005  
**TO:** Members – Revenue and Transportation Interim Committee  
**FROM:** Mike Green  
**RE:** Amendment of Montana source income rule – MAR Notice 42-2-754

I represent the Montana Taxpayers Association (Montax), which along with the Montana Association of REALTORS® (MAR), requested that I draft this memo. Both organizations are concerned about the potential impacts of the Department of Revenue's proposed rule amending the definition of Montana source income. We believe the proposed amendment is a fundamental change in Montana's tax policy that conflicts with the current policy of encouraging capital investment in the state. We are writing to urge that you object to this rule because we believe that any such change should be considered by the Legislature rather than an executive branch agency.

The proposed amendment changes the definition of Montana source income to state that deferred gains retain their Montana source character regardless of the deferral method. The two types of transactions specifically discussed in the proposed language are installment sales and like-kind exchanges. We believe the language regarding installment sales is consistent with current law, and have no objection to that language. However, the proposed amendment adopts a significant change to Montana's treatment of like-kind exchanges (often referred to as 1031 exchanges because they are authorized by § 1031 of the Internal Revenue Code).

It is our understanding that the director and his staff believe the proposed rule amendment is simply a clarification of existing law necessary to eliminate confusion that exists about taxation of deferred gains. We respectfully disagree. The proposed rule will fundamentally change the way Montana taxes gains on real estate sales that occur after a like-kind exchange.

Under the IRC, taxpayers can defer gain (and federal income tax) on the sale of property if they use one of the IRC's deferred gain provisions. The most widely known provision is §1031, which allows deferral of gain on like-kind exchanges, in an effort to encourage reinvestment of capital into productive property. Under the IRC, the taxpayer pays tax on the gain from business or investment property only when it is ultimately sold. However, when states adopt deferral rules similar to §1031, significant sourcing problems can arise. For example, the IRS, and by extensions most states, treat property located in one state as "like-kind" for property located in another state. This treatment does not create federal tax issues because the IRS can tax gains from the final sale regardless of where the property sold is located. However, states do not have the same authority is significantly more limited than that of the IRS. State authority has some connections. Therefore, states must determine whether

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before a state can tax income from the sale of property. We maintain that this determination should be made statutorily by the Legislature.

Montana's individual income tax law currently assesses tax on two types of income: all residents' income and all non-residents' "Montana source income." In this sense, Montana joins most states in assessing all income earned by its residents, regardless of source, and all income earned within its borders, regardless of recipient. Montana similarly joins most other states in not taxing income by non-residents from outside the state. In terms of like-kind exchanges by non-residents, Montana currently taxes all the gain from property acquired in an inbound exchange. Montana does not tax the gain from property acquired in an outbound exchange.

The Department's proposed amendment would allow Montana to tax income recognized of nonresidents in the sale of property acquired through an outbound like-kind exchange with Montana property. Adoption of this change would put Montana in the minority of states, and alone among those bordering us, in taxing such out-of-state sales. As such, the adoption of this proposed change may put Montana at a further disadvantage in the competition for out-of-state capital.

In our discussions with Director Bucks, he indicated that the pending amendment proposal is only first step in a process of defining what gains constitute Montana source income. We understand that it is his intent that Montana would ultimately only tax non-residents on the Montana portion of gains from any deferred gain transaction regardless of whether the deferral results from an inbound or outbound exchange. While Director Bucks believes this is the intent of Montana's current statutes, he acknowledged that implementing this treatment requires additional rulemaking or guidance. As a result, even in the best case scenario, the current proposed amendment is incomplete.<sup>1</sup>

The theory of taxing deferred gains that Director Bucks outlined to us has a certain "common sense" appeal. However, it is not the approach applied by most of the states at this time. Further, we do not agree that it is the intent of the current statutes, nor do we believe it will be as easy to administer as the current system. We welcome the Department's interest in exploring ways to improve Montana's taxation of nonresident incomes. However, we believe that any such "improvements" should be considered as a package, rather than piecemeal. More importantly, given the potential economic implications of changing the taxation of nonresidents, we believe the Legislature is the appropriate body to consider such a change. As such, we urge the Committee to formally object to the Department's proposed amendment noticed at MAR Notice No. 42-2-754.

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<sup>1</sup> While it is possible that Director Bucks' proposed changes would ultimately result in Montana taxing less than it currently does, we are unable to fully evaluate the impact of Director Bucks' entire proposal until it is reduced to a complete draft. Until such a draft can be completed, we believe it is premature for the Department to consider this rulemaking.