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DATE: September 10, 2010
TO: Revenue and Transportation Interim Committee
FROM: Jaret Coles, Staff Attorney
SUBJECT: Agricultural Land: Summary of Value Before Reappraisal (VBR) Issues

Summary

This memorandum presents some of the potential issues that were brought before the Agricultural and Forest Land Subcommittee (AFLS) regarding the phase-in of values on agricultural property. It summarizes what I understand to be the general positions of the Department of Revenue (Department) and certain taxpayers, and it is not a legal opinion. The Department and/or the taxpayers may disagree with aspects of this summary. It is also possible that some of the issues are not widespread and that more factual information is needed.

This memorandum consists of five examples, and it uses charts and tables in an attempt to simplify some fairly complex issues. The first example shows what happens during the reappraisal cycle when a property does not contain newly constructed, remodeled, or reclassified property. The second example shows what happens when the Department discovers a classification change during the reappraisal cycle. The third example presents a potential issue that was raised by the petitioning taxpayers in *Lucas v. Department of Revenue*. The fourth and last example presents a potential issue that was raised by an individual taxpayer in the AFLC regarding a reduction in the phase-in when a road was discovered.

Agricultural Land: The Phase-In Varies

Montana's Constitution directs the state to appraise, assess, and equalize the valuation of all property which is to be taxed in the manner provided by law.¹ The Montana Supreme Court has determined that when "it is impossible to secure both the standard of the true value, and the uniformity and equality required by law, the latter requirement is to be preferred as the just and

¹ Mont. Const. Art. VIII, § 3.

ultimate purpose of the law.”² By statute, the Montana Department of Revenue (Department) is required to classify and appraise land based on an equitable and uniform basis.³ This includes the administration and supervision of a program for revaluation of all taxable property within class three (agricultural land) every 6-years.⁴

Pursuant to statute, agricultural land must be classified according to its use, which classifications include **but are not limited** to irrigated use, nonirrigated use, and grazing use.⁵ The Department’s rules provide that agricultural land falls into five use classes, including grazing, nonirrigated summer fallow farm land, irrigated, nonirrigated continuously cropped hay land, and nonirrigated continuously cropped farmland.⁶ Within each class, land is subclassified by production categories.⁷ (see Appendix A for excerpts of select statutes and administrative rules).

The issue before the Committee arises out of the Department’s phase-in of the valuation changes implemented as a result of its comprehensive reappraisal of agricultural properties throughout the state. The following examples demonstrate some of the impacts of the Department’s decisions regarding the phase-in process.

I. EXAMPLE ONE: STRAIGHTFORWARD PHASE-IN.

Agricultural property reappraisals occurred in 2008. As part of a mitigation strategy, these reappraisal values are generally phased in over the 6-year reappraisal cycle. Section 15-7-111(3), MCA, provides that the amount of the change in valuation from the 2002 appraisal year must be phased in each year at the rate of 16.66% of the change in valuation. This has the effect of lowering the amount of tax paid in the beginning years. For example, if a parcel of grazing land had a productive value of \$1,000 during the 2002 reappraisal and it is reappraised at a value of \$1,600 in 2008, the \$600 difference between the old value and the new value is phased in over a period of 6 years in order to reduce the impact of the valuation change.⁸ As such, in this example the taxpayer would have a taxable value of \$1,100 in tax year 2009, \$1,200 in tax year 2010, \$1,300 in tax year 2011, \$1,400 in tax year 2012, 1,500 in tax year 2013, and \$1,600 in tax year 2014. The value before reappraisal (VBR) is the \$1,000 pre-reappraisal value (*i.e.*, 2002 appraisal), which is essentially the starting point for the phase-in. However, the term VBR is only referenced in one statute pertaining to the property tax assistance program, and no statutory definition exists.⁹ Nonetheless, the VBR calculation can change the amount of property taxes that a taxpayer faces.

² *Mont. Dept. of Rev. v. St. Tax App. Bd.*, 188 Mont. 244, 249, 613 P.2d 691, 694 (1980) (quoting *Sioux City Bridge Company v. Dakota County*, 260 U.S. 441, 446 (1923)).

³ §§ 15-7-101, 15-7-103.

⁴ § 15-7-111, MCA.

⁵ § 15-7-201(2), MCA.

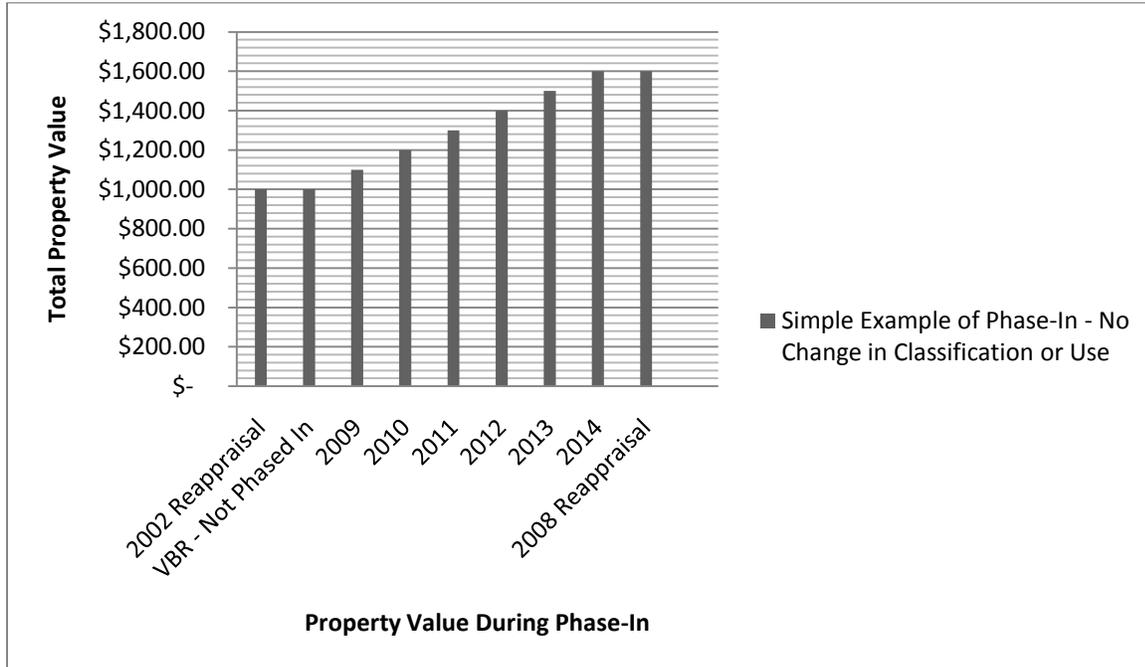
⁶ ARM § 42.20.601(8).

⁷ § 15-7-201(3), MCA.

⁸ See ARM § 42.20.503.

⁹ See § 15-6-193, MCA

The following example shows the phase-in when there is no newly constructed, remodeled, or reclassified property:



Year	Data
2002 Reappraisal	\$ 1,000
Not Phased In	\$ 1,000
2009	\$ 1,100
2010	\$ 1,200
2011	\$ 1,300
2012	\$ 1,400
2013	\$ 1,500
2014	\$ 1,600
2008 Reappraisal	\$ 1,600

II. EXAMPLE TWO: THE PHASE-IN IS ADJUSTED WHEN PROPERTY IS RECLASSIFIED.

Section 15-7-111(2), MCA, provides that Department “shall value and phase in the value of *newly constructed, remodeled, or reclassified* property *in a manner consistent with the valuation within the same class*” and the values established pursuant to the revaluation program.¹⁰ In order to accomplish this mandate, the Department was given rulemaking authority, and the statutes do not specifically cover how this is to be accomplished. The Department’s rules define “land reclassification” *as changing the use of land from one type of agricultural use to a different type of agricultural use.*¹¹ The rule provides an example showing that a land reclassification occurs when agricultural land that was previously used as grazing land is converted to irrigated land. Furthermore, the rules provide that when a reclassification occurs the “current year VBR will be the prior year VBR *of the new classification* or land use change.”¹² The Department interprets these provisions by recalculating a new VBR when a parcel has a change in size or use. The recalculated VBR may be based on productivity information from the most recent reappraisal cycle and commodity prices from the 2002 reappraisal cycle.

As an example, assume that the land in the above example is agricultural land. Assume further that the land was classified as grazing land, despite the fact that it has been used as irrigated land (*i.e.*, a different class) since 1969. As part of the reappraisal process, the Department discovered the land was irrigated land. This discovery increased the production value from \$1,000 to \$11,000. The Department does not phase-in the \$10,000 change during the 6-year period. Instead, the Department adjusts the VBR (*i.e.*, the recalculated VBR or 2002 value). In this example, it is assumed that the Department determined the land had a \$10,000 (instead of \$1,000) value during the 2002 reappraisal cycle. As such, the amount that is phased in over the 6 year period is the \$1,000 difference between the recalculated VBR of \$10,000 and the 2008 reappraisal value \$11,000, which equals a phase-in of \$167 per year ($\$1,000 \text{ change in value} / 6 \text{ years} = \167 per year).

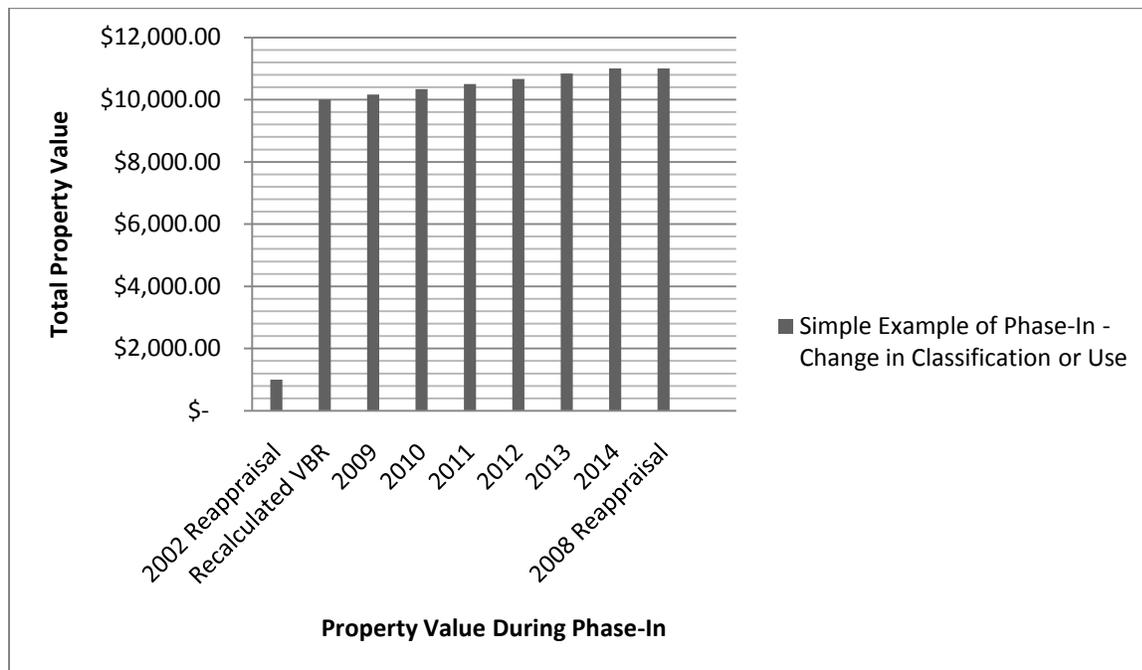
The \$9,000 change in value ($\$10,000 - \$1,000 = \$9,000$) resulting from the reclassification is not phased in. Consequently, the VBR is raised to \$10,000 instead of \$1,000. The taxpayer’s land would have a production value of \$10,167 in 2009, \$10,334 in 2010, \$10,501 in 2011, \$10,668 in 2012, \$10,835 in 2013, and \$11,000 in 2014. The value before reappraisal (VBR) or recalculated VBR is \$10,000 in this example.

¹⁰ § 15-7-111(2), MCA (emphasis added).

¹¹ ARM § 42.20.501(13).

¹² ARM § 42.20.502(2) (emphasis added).

The following example shows the phase-in based on the reclassified property:



Year	Data
2002 Reappraisal	\$ 1,000
Not Phased In	\$ 10,000
2009	\$ 10,167
2010	\$ 10,334
2011	\$ 10,501
2012	\$ 10,668
2013	\$ 10,835
2014	\$ 11,000
2008 Reappraisal	\$ 11,000

Summary of My Observations Regarding the Department’s Position for Example Two:

It is generally¹³ the Department’s position that many valuation changes result from processes other than the simple accretion of price over time. For example, an owner of a large home may convert its use to a bed and breakfast. Other residential property may be modified by significant

¹³ See Affidavit of Dallas Reese in *Lucas v. Mont. Dept. of Rev.*, pp. 8-11 (Apr. 26, 2010).

additions of floor space. A farmer may apply irrigation to a formerly dry parcel. These tangible changes and their attendant change in value are not the result of a periodic reappraisal but occur by action of the owner changing the productive use of the property and should not, in fairness, be subject to the phase-in. When the Department discovers a change to the physical characteristics of any property that result in a classification change, that change in classification is implemented immediately in the year following the discovery. The manner of this administration and its interpretation affects how the base value (or VBR) is determined for the phase-in process. It is the Department's position that recalculating the VBR places taxpayers who were previously undertaxed on equal footing with the taxpayers who had their land properly classified.

The Department states that its normal process in determining the recalculated VBR is to calculate a 2008 value to use as the starting point for the phase-in. The calculated value may use 2008 crop production figures instead of 2002 production figures, as it is the most readily available information. The calculated value also uses commodity data from the 2002 cycle.

Summary of Petitioners' Position in the Lucas Case for Example Two:

It is the position of some taxpayers that the entire change in value of \$10,000 (\$11,000 new appraisal - \$1,000 from the old appraisal) should be phased in during the reappraisal cycle. This has the effect of "transitioning" the grazing land to irrigated land over the reappraisal cycle. In the *Lucas* pleadings taxpayers cited to the fact that the Department did not update its administrative rules to reflect a definition of VBR that is applicable to the current reappraisal cycle. As such, some taxpayers argue that section 15-7-111(3), MCA, which provides that "the change in valuation from the 2002 base year for each property in classes three, four, and ten must be phased in each year at the rate of 16.66% of the change in valuation", takes priority over the rules.

Petitioners also argue that the assessment notices do not provide the recalculated VBR, or identify the data or formula the Department used to calculate the 2009 taxable value, and that the Department should not rely on productivity information from the most recent reappraisal cycle to determine the VBRs for all agricultural land.

III. EXAMPLE THREE: AN EXAMPLE FROM LUCAS RANCH REGARDING DIGITAL MAPPING CHANGES.

During the reappraisal process the Department utilized digital mapping in order to determine whether property was properly classified. Based on this advanced technology, the Department determined that a section of land (*i.e.*, 640 acres) owned by Lucas Ranch Inc. had 63.87 acres of tillable irrigated grazing land instead of 60.40 acres (3.47 acres increase). This change reduced the amount of grazing land in the section from 578.60 acres to 575.13 acres (3.47 acre reduction).¹⁴ The Department determined this was a classification change for the entirety of both

¹⁴ The section also consists of a 1-acre farmstead.

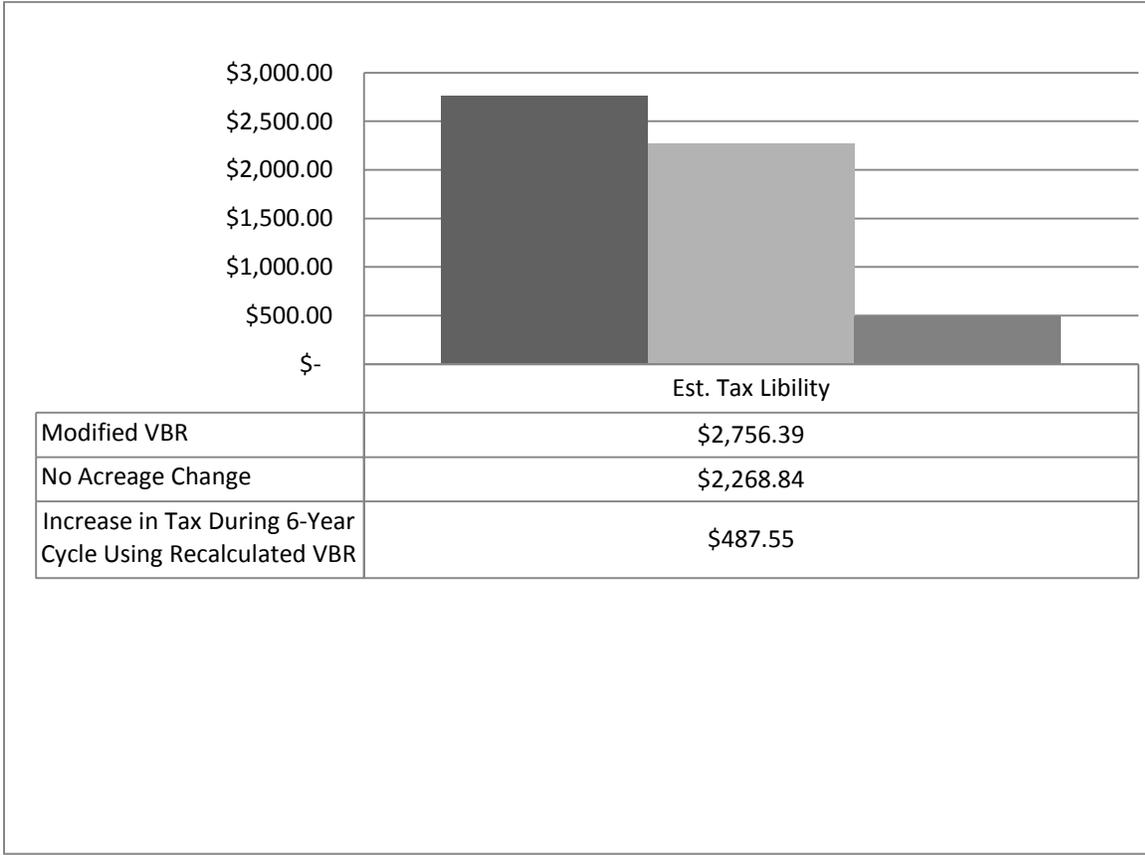
the irrigated land and the grazing land, and the 2002 assessed value was not used as the VBR. Instead, the Department recalculated the VBR by adjusting it to take into account the production capacity of the irrigated and grazing land based on their change in size and an estimate of production capability. It is unclear what production data the Department relied on (*i.e.*, 2002, 2008, etc.). However, Lucas Ranch owns multiple sections of land, some of which may have multiple classification changes that are more complex than this example.

If the grazing land did not have a decrease in size (*i.e.*, a classification change), the statute requires VBR to be calculated by using the full 2002 reappraisal value without any adjustments. As applied here, the 2002 per-acre value for the grazing land without any adjustments was \$40.96, and the 2008 per-acre value using the full 2008 reappraisal was \$93.77. However, based on the classification or use change, the Department determined that the grazing land actually had a higher market value in 2002 than initially reported during the 2002 valuation. The Department's recalculated VBR was approximately \$76.39 per acre (see Appendix B for a description of the steps that a taxpayer would need to take to determine the recalculated VBR). As such, the amount that will be phased in over the 6-year period is the \$17.38 (per acre) difference between the recalculated VBR of \$76.39 and the 2008 reappraisal value of \$93.77 (per acre), which equals a phase-in of \$2.90 per year ($\$17.38 / 6 \text{ years} = \$2.90 \text{ per year (per acre)}$).

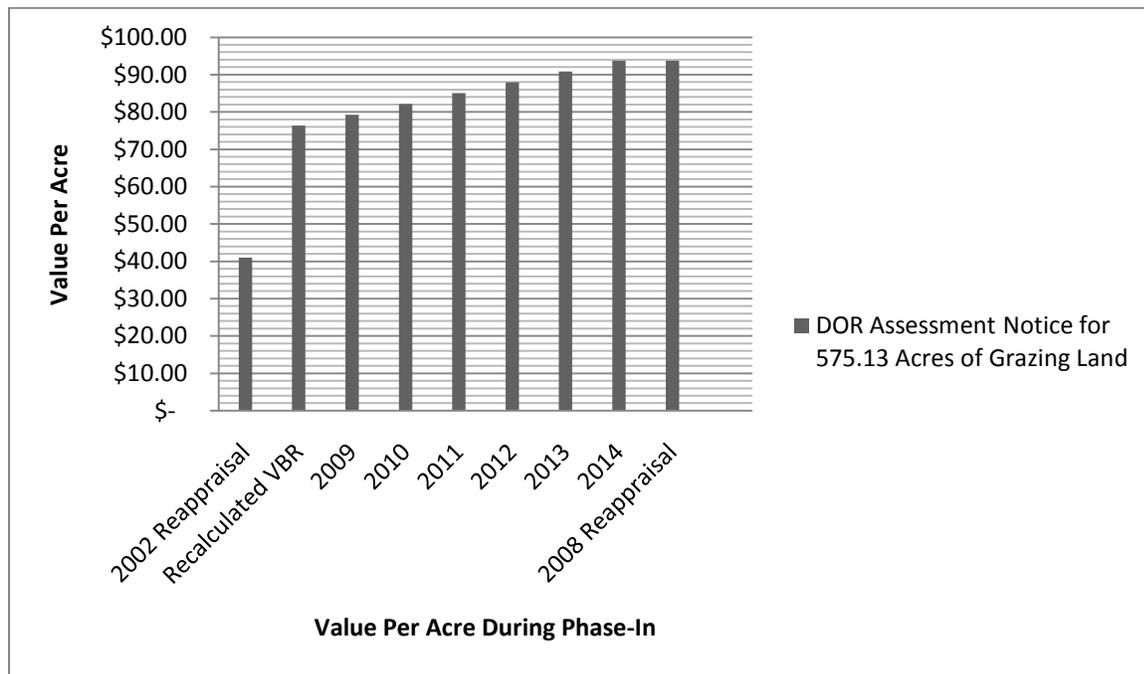
The \$35.43 (per acre) change in value resulting from the reclassification or land use change is not phased in. The VBR is raised to \$76.39 (per acre) instead of the 2002 value of \$40.96. The taxpayer has an approximate market value per acre of \$79.29 in year one, \$82.19 in year two, \$85.08 in year three, \$87.98 in year four, \$90.87 in year five, and \$93.77 in year six.

The following charts provide an easier-to-understand analysis of the digital mapping change:

6-Year Tax Impact on 575 Acres of Grazing Land

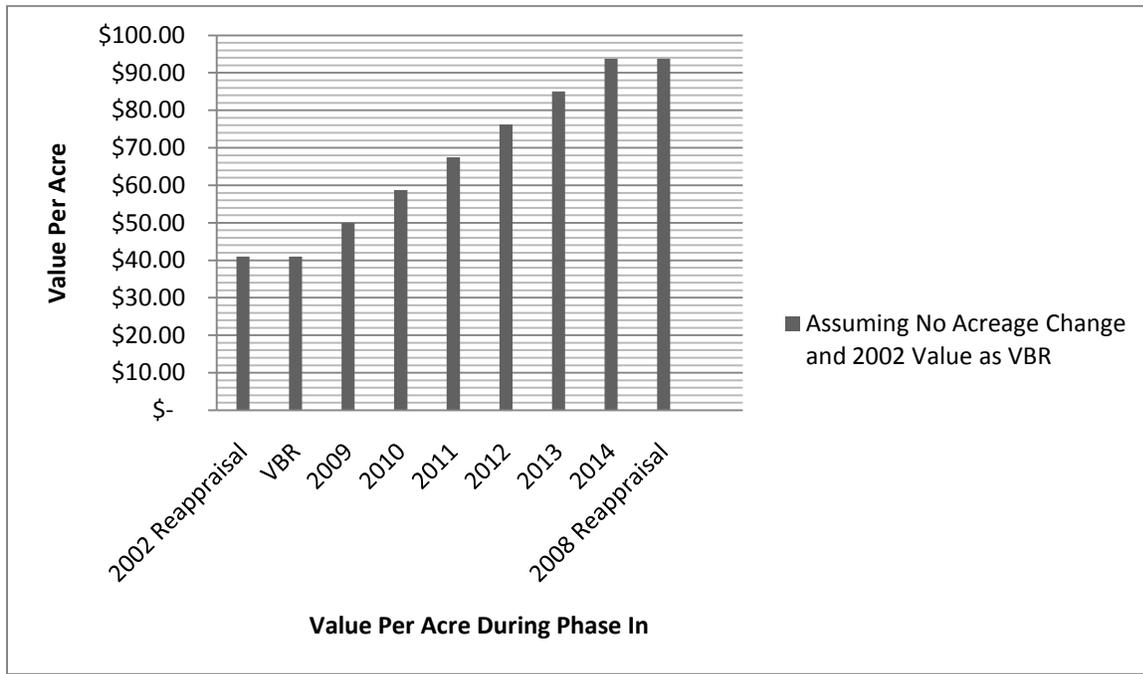


Per-Acre Phase-in Based on DOR Assessment Notice and Recalculated VBR



Year	Data
2002 Reappraisal	\$ 40.96
Not Phased In	\$ 76.39
2009	\$ 79.29
2010	\$ 82.19
2011	\$ 85.08
2012	\$ 87.98
2013	\$ 90.87
2014	\$ 93.77
2008 Reappraisal	\$ 93.77

Per-Acre Phase-in Based on No Acreage Change and 2002 Value as VBR



Year	Data
2002 Reappraisal	\$ 40.96
Not Phased In	\$ 40.96
2009	\$ 49.97
2010	\$ 58.72
2011	\$ 67.48
2012	\$ 76.23
2013	\$ 84.99
2014	\$ 93.77
2008 Reappraisal	\$ 93.77

Summary of My Observations Regarding the Department's General Position:

It is generally the Department's position that a recalculated VBR must be computed pursuant to the statute and administrative rules regarding classification changes. Additionally, in an unrelated rulemaking hearing the Department mentions various considerations as to why this is not a simple process. The Department addressed the complexity as follows:

(a) The 2003 reappraisal information is tabular information only. The provenance of the 2003 acreage information is only largely unknown because:

(i) The tabular information was acquired using a land measurement technique based on a "dot grid." A dot grid is a simple measurement tool comprised of a clear plastic sheet containing numerous evenly spaced dots. Each dot represents an acre and the dot grid is based on a map scale of 1 inch to the 1/4 mile, or 4 inches per mile or typical section of land. The dot grid is placed on whatever available appropriately scaled map or aerial photograph and dots are counted to determine the acreage within a field by land use classification.

(ii) The hard copy maps initially used in conjunction with the dot grid have not been maintained in a comprehensive fashion and are either completely or partially missing, or are outdated in most locations.

(iii) The available hard copy maps are in a wide variety of formats and map scales including black and white aerial photos from the 1960s or 1970s; hand drawn mylar maps; and/or hand drawn paper maps. The most recent updates or maintenance of these maps/photos is unknown but is assumed to be in the early 1980s. The final potential source of the acreage information could come from "commissioners' books" which also have an unknown maintenance date, however, the last maintenance is assumed to be in the late 1960s or early 1970s.

(iv) If the department were to use the hard copy maps, manual intervention and review of the maps would be required on a parcel by parcel basis. A dot grid would have to be used to try and identify the associated acres reflected in the tabular data. Matching the acreages as shown on the 2003 appraisal record with the acreage determined through the use of a dot grid would require multiple attempts to match the acreage exactly. Without this manual intervention there is no other way to determine which of the prior acres associated with the grazing land were converted to the crop land use.

(b) The time and effort associated with manual intervention is not cost-effective.

(c) The 2003 range land productivity information is a broad indication of the overall carrying capacity of the land. The 2009 productivity is a specific soil by soil determination of the carrying capacity.

(d) Determining which of the remaining 280 acres contained in the 2003 information corresponds to the 2009 soil specific acres requires manual intervention outlined above.

(e) Determination of the correct value before reappraisal for these 280 acres would require a manual calculation using the 2003 valuation inputs. The current Property Valuation Assessment System (PVAS, commonly known as Orion) does not contain a program for calculating these values and the calculation of the value of the 280 acres would have to be done manually and external to the Orion computer system.

(f) The calculated value associated with the new 2003 acres (280 acres) would not correspond to prior assessment notice valuation information received by the landowner.¹⁵

Summary of Petitioners' Position in the Lucas Case for Example Three:

The Department's use of a recalculated VBR stems from its assertion that any change to any land within a parcel constitutes a "reclassification" for the entire parcel. Thus, the move of 3.47 acres from grazing land to irrigated land was deemed a reclassification of the entire 640-acre section.

It is the position of some taxpayers that VBR should go down when a parcel is reduced in size, not up. The method taxpayers would use is mathematical, and the 2002 reappraisal values are reduced based on the percentage of grazing land that was removed during the 2008 reappraisal.

IV. EXAMPLE FOUR: AN EXAMPLE REGARDING A CHANGE IN USE BASED ON DISCOVERY OF A COUNTY ROAD.

The Agricultural and Forest Land Property Reappraisal Subcommittee received testimony from a taxpayer (not the *Lucas* case) indicating that the VBR associated with a parcel increased when a county road was discovered. After performing an analysis of approximately 1,000 parcels, the Department was unable to identify a parcel where the discovery of a county road was the only change.

It is unclear whether a recalculated VBR is used when a "noncounty" road is discovered, but presumably this does not occur since an administrative rule provides that roads "that do not transfer title to such rights-of-way are taxable and will be classified and valued as adjoining agricultural land". ARM § 42.20.610.

¹⁵ Mont. Dept. of Revenue, Notice of Adoption, Mont. Admin. Reg. No. 42-2-828 (June 10, 2010) (response one).

Summary of My Observations Regarding the Department's General Position:

It may be the Department's position that when the discovery of a county road reduces the size of a parcel, a recalculated VBR must be computed. In an unrelated rulemaking hearing the Department mentions various considerations as to why this not a simple process. The Department addressed the complexity as follows:

The department correctly phased in lands with acreage changes and classification changes in accordance with ARM 42.20.605. Furthermore, the proposed rule does not apply to county roads. This question poses an interesting circumstance for the department. In addition to the response in Comment No. 1, a consideration of the number of changed acres must be discussed. Or to be more specific, how many acres are required before a classification change is considered to have taken place?

As noted in the response to Comment No.1, the department has no means to accurately and efficiently compare the changes that occurred between the appraisal cycles by using prior maps. As a result, the department would have to rely on some electronic means of comparing the acreage change between appraisal cycles. While the math to make the comparison seems straightforward, the results can cause significant differences.

Early on in the reappraisal process, the department considered different scenarios. The first scenario included a determination of a percentage of changed acres on a parcel. If some fixed percentage of acres has changed between appraisal cycles, then a classification change would be deemed to have taken place. If an acreage change has occurred that is less than the established fixed percentage, then a classification change would not be deemed to have taken place. The determination of the fixed percentage is highly speculative and results in an uneven application of the standard. For example, if the fixed percentage is deemed to be 1%, then a 640-acre parcel of grazing land would need to exhibit a change of 6.4 acres or more before being considered as having undergone a classification change.

A roadway is typically 60 feet wide. If half of the roadway is 30 feet wide and is deducted from the full mile length associated with the above section of land (on one side only) then 3.6 acres

would be separately identified ($5,280 \times 30' = 158,400$ square feet; $158,400 \div 43,560$ square feet per acre = 3.6 acres). In this example the land would not be considered to have undergone a reclassification since less than 6.4 acres were changed. If there is a road on two sides of the section then the land would have been considered to have undergone a classification change as 7.2 acres would have been changed.

But, consider a smaller tract of land of 40 acres. For a quarter-quarter section a change of .4 acres or more would be considered a reclassification. A quarter-quarter section is 1/4 of a mile long. Following the same calculation but using 1,320 feet for road deduction, the affected acreage is .91 acres ($1,320 \times 30 = 39,600$; $39,600 \div 43,560 = .909$ acres). Since anything larger than a .4-acre change would be considered a classification change, this 40-acre parcel would be considered to have been reclassified.

As can be seen, a fixed percentage change does not treat all landowners equally. If the fixed percentage of change is higher or lower than the example, the same results occur. Which leads to the second concern - "why choose one percentage over any other?" If the fixed percentage is 1%, why wouldn't 1.25% be better, or 1.5%, or 1.75%? Any determination of a fixed percentage change is arbitrary and is not a defensible mechanism for recognizing classification changes.

Consideration must also be given to legitimate classification changes. For example, many nonirrigated hay fields are small and can easily be less than 6 acres in size. For the section of land identified above, a 6-acre hay field would have to be physically identified and excluded from the provisions of classification changes. A simple math equation would either not work or would improperly identify the parcel as having no change in classification.

A third consideration was to establish a fixed acreage change which has the same arbitrary effect based on parcel size. For example, 6.4 acres is 1% of a normal section of land but is 16% of a 40-acre parcel of land. Again an inequity of the application of a fixed acreage causes concern and the decision on the fixed acreage amount becomes arbitrary.

The department conducts appraisal on a statewide basis and all potential circumstances must be reflected in any decision to accommodate classification changes. Creating a means to identify

parcels that have or have not had classification changes is a slippery slope and one that would need much more detailed investigation. The department determined that a reappraisal, as mandated by 15-7-111, MCA, will result in changes to agricultural land use. Among other purposes a reappraisal is a means to provide compliance with other Montana statutes related to the current classification of land. A classification change, no matter how minor, should be treated in a consistent and equitable manner as described in law.¹⁶

Summary of the Individual Taxpayer's Position for Example Four:

In a statement during a rulemaking comment period, one taxpayer mentioned that in reality nothing has changed on the ground in real life, only the reappraisal process making, supposedly, more accurate acreage changes. The individual claimed that parcels of land that in reality didn't have either size or use changes would be removed from any meaningful phase-in of their increase in value. Lastly, the individual claimed that the process used with the mapping system of the parcels of land is flawed.¹⁷

¹⁶ Mont. Dept. of Revenue, Notice of Adoption, Mont. Admin. Reg. No. 42-2-828 (June 10, 2010) (response two).

¹⁷ See *id.* (comment two).