

January 20, 2022

Constitutional Initiative 121

Proponents of a proposal to limit property taxes paid by homeowners have prepared CI 121. This is an initiative to amend the Montana Constitution to limit the amount of property taxes that can be assessed against residential property. The initiative does the following:

1. Rolls the value of residential property back to the value of the property as January 1, 2019.
2. Limits the increase and decrease in the value of residential property affected by the initiative to the lesser of inflation or 2%.
3. Limits the taxes assessed against residential property to no more than 1% of the market value.
4. Allows for new valuation upon change of ownership, new construction, or significant improvement to the property.
5. Requires the 2023 Legislature to define what residential property is.
6. Allows the Legislature to use acquisition value to value other types of property through legislation.

What legislative action will be needed if CI 121 passes?

CI-121 is not self-executing, meaning that the Legislature will need to pass enabling legislation during the next session to comply with the requirements of the initiative and to deal with administrative issues the change in the Constitution necessitates.

The required action for the Legislature is to define what residential property is. Currently residential property is generally all class IV property that are single family dwellings and most multi-family dwellings of four or less units, lots associated with those properties and bare land that is divided into single lots. Larger properties, while still class IV, are generally classified as commercial property and have a higher tax rate, 1.89% vs. 1.35% for residential property. Homes valued over 1.5 million dollars are also residential property under current law but are taxed at the 1.89% commercial rate.

How might the Legislature define residential property?

The Legislature could approach this requirement several ways:

1. Use the current methodology of classifying residential property which would be the broadest application. This would limit the taxes on all current class IV residential property and value it at 2019 values inflated. It would also require this property be valued at market value upon transfer or improvement.
2. Use definitions for residential property similar to what are used in current statute that provide targeted tax relief to elderly homeowners and certain income tested programs. These generally require a minimum owner occupancy time of 7 months. A definition like this would reduce the number of properties the initiative applies to. Rental properties, bare land, and second homes would not qualify.
3. Create a definition of residential property that covers the most properties that are residential which could include rental properties, vacation homes, or other properties the Legislature thinks should be afforded the protections of the initiative.

What other issues should the Legislature consider addressing?

With the change in valuing residential properties and limiting the property taxes on residential property there will be many challenges in both administration of the property tax system and funding of local governments and schools that the Legislature will need to address. Currently all class IV residential properties account for almost of one half of the property value in the State and pay over one half of the property taxes since most residential property is located in cities where mill levies are higher. Limiting the amount of taxes this property pays will have significant effects on tax revenues. The Legislature will need to amend many current statutes to deal with impacts.

Will the current mill levy system need to be altered to accommodate the tax limit on residential property?

All properties in a levy district have the same number of mills applied to them. A levy district is an area where all the properties in the levy district pay mills to the same taxing entities that provide them services. These entities could be state, county, city, school districts, and special districts that collect taxes based on the value of the property. Currently, there is no provision that allows some properties in the levy district to pay different mills than other properties. Because of the 1% cap on residential taxes, the maximum levy that could be imposed in a levy district is limited by the mills that would cause residential property to reach the 1% limit. That mill cap is 740 mills, ($1/1.35 = .740$), in a levy district that has no homes valued over 1.5 million dollars. If a district had a home valued over 1.5 million dollars the cap would be 529 mills, ($1/1.89 = .529$). If this scenario happens, revenue shortfalls to schools and local governments could be noticeable depending on how the legislature defines residential property. If the total mills in a levy district had to be reduced to 740 mills, all property in the levy district would receive a tax reduction. Many residential properties are currently below the 1% of value cap as

they are low mill areas, and the cap would not apply to them until mill levies increased above the 740 mill threshold. The Legislature will need to adopt policy that insures residential property taxes do not exceed 1% of value when the total levies by all government entities are imposed.

What changes in the property tax system could the Legislature propose?

1. The Legislature could change the process so residential property did not pay taxes by mill levy. Revenue from residential property would be considered non levy revenue and distributed to taxing entities in proportion to each entities levy. They could just base residential property taxes on the maximum 1% of value and allow the State, schools, and local governments to assess 1% of the homes value instead of applying a tax rate and mill levy to residential property. The law could then allow mill levies to be applied to all non residential properties as is currently done. Modifications would have be made to 15-10-420, the current property tax limit statute to make this work. Doing so would attempt to keep property tax revenues whole but would shift taxes from residential property to all other classes of property.
2. The Legislature should consider repealing the differential tax rate for properties over 1.5 million dollars as this will simplify the system and the 1% cap will still collect about the same revenue from these properties. This would increase the mill cap on these properties from 529 mills to 740 mills. This would also deal with one of the mill cap problems discussed above.
3. The Legislature could apply acquisition value and the 1% cap to all properties through statute. This would give all property owners the same protection as residential property. It would also remove the significant discrimination in taxes per dollar of value embedded in the current system. This would cause significant revenue shortfalls for all property tax dependent entities. Tax limit protections passed through statute would not have the protections accorded residential property with their constitutional protections.
4. The Legislature will need to address how revenue shortfalls created by reducing the taxes on some residential properties will be apportioned between all the entities that collect property taxes. Currently the State collects about 15% of the property taxes a residence pays. Schools collect the largest amount, some around 50%. Counties collect about 25%, and cities collect 20%, with special districts and the university system also collecting property taxes. The amount of revenue shortfalls in any jurisdiction will be unique to the jurisdiction. Some jurisdictions will not have any revenue shortfall as their residential property is currently paying less than the 1% cap. Almost all the residential property affected by CI-126 lies in cities and towns. If for example, the mill cap is 740 mills and a residential property in a city is paying 850 mills, its taxes would be reduced to the amount 740 mills would collect. That 90 mills no longer collected would have be apportioned among all the property taxing jurisdictions in some matter determined by law.
5. Another issue that CI-121 will create is the application of voted levies. In California where this concept originated, voted mill levies apply to all properties and are above the 1% cap. That would not be permissible in Montana as the language in the Constitutional amendment does not allow for property taxes to exceed 1% of residential value. Statutory changes could not override this protection. Therefore, voted mill levies if allowed, would only apply to those properties not protected by the 1% constitutional cap. This would create incentives for protected residential property owners to support mill levy increases as they would be shielded from paying them.

6. The legislature should define the criteria for transfer of ownership to assure that full value is reported in order to establish true market value.

7. The legislature will have to address through statute what constitutes a significant improvement that would trigger revaluation of the property. This issue is one of the most contested processes in States that use acquisition value and would likely be an issue with the system imposed by CI-121.

8. The Department of Revenue will have to maintain databases to track values of homes changing ownership, adopt rules defining an arms-length transaction, as well as methodologies to be used to value improvements. They will need to modify their property tax system to apply the inflation factor to residential properties each year. They will also have to develop methodology to locate and appraise improvements.

Conclusion

CI-121 will achieve the goal of protecting property owners who are defined as residential after the passage of the initiative from the uncertainty of ever-increasing property taxes. It will also provide some stability to property tax revenues depending on how the legislature implements the measure. There are risks to those taxpayers who are not defined by the legislature as residential as they may experience tax shifts if property taxing entities increase levies to backfill shortfalls caused by reductions from the roll back to 2019 values of residential property and because residential values will not be increasing at previous rates. There will still be overall increases in residential property taxes due to revaluation upon transfer or improvement as well as new residential properties coming on line. There will be administrative challenges at both the State level and the local level as CI-121 creates a system that treats residential property differently than the other types of property.

The passage of CI-121 will produce one of the following results:

1. Property tax collections will drop significantly if the mill cap option prevails, and levies are capped on all property at 746 mills.

2. Taxes will shift from property defined by the Legislature as residential to all other property as taxing entities raise mills to backfill revenue lost due to roll back in valuations and limited change in values applied to residential property.