Final Report of the Interim Legislative Tax Reform Study Committee
Memorandum

To: Governor Judy Martz
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   Senator Bob Keenan, President of the Senate
   Senator Fred Thomas, Majority Leader
   Senator Jon Tester, Minority Leader
   Representative Doug Mood, Speaker of the House
   Representative Roy Brown, Majority Leader
   Representative David Wanzenried, Minority Leader
   Senator Robert Story, Rev. and Trans. Interim Committee Chair

From: Senator Keith Bales, Committee Chairman

Date: December 1, 2004

Subject: Final Report for the Tax Reform Legislative Study Committee

The interim Tax Reform Study Committee, established by the 58th Montana Legislature in Senate Bill 461, has completed its comprehensive examination of taxation in Montana.

As provided for in the enabling legislation, the interim Tax Reform Study Committee was charged with conducting a comprehensive examination of taxation in Montana, to include recommendations and proposals for revising the existing tax structure and considering alternative forms of taxation.

In accordance with the requirements of Senate Bill 461, the interim Tax Reform Study Committee herewith submits for your review and consideration the final report of its findings and recommendations.

Enclosures: Final Report
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Executive Summary

Senate Bill 461 (2003 Legislative Session), 58th Legislative Assembly, created the interim Tax Reform Study Committee. The Committee was charged with studying all aspects of Montana taxation and providing recommendations and proposals for tax reform to the Montana Legislature by December 1, 2004.

A detailed discussion of the Tax Reform Study Committee’s charge, deliberations, findings, and recommendations is provided in the following full report of the Committee. This Executive Summary provides a brief and concise overview of those findings and recommendations.

Major Interim Developments

During the interim, two major events occurred that had significant bearing on the work and recommendations of the Tax Reform Study Committee. These events also bear directly on the work of the upcoming 59th Legislative Assembly.

School Funding

On April 15, 2004, Judge Jeffrey Sherlock, Montana 1st Judicial District Court, issued a decision in the matter of Columbia Falls Elementary District, et. al. v. State of Montana. In essence, Judge Sherlock found that Montana’s current system of funding schools violates state constitutional provisions pertaining to school funding.

Among other things, Judge Sherlock found that the current school funding system is not based on educationally-relevant factors; that Montana’s public schools are not adequately funded; and that the state is not paying its share of the cost of basic elementary and secondary education. Judge Sherlock’s decision was subsequently appealed to the state Supreme Court. On November 8, 2004, that body issued a preliminary order that generally upheld the findings of the lower court.

Of direct importance to the Tax Reform Study Committee were the implications of the Court’s findings as they relate to revenue requirements. Some experts have indicated that full compliance with the Court’s findings could require additional funding of as much as $350 million per year; others have suggested that adequacy and the state’s share of funding can be addressed in part through efficiency initiatives, and that additional funding requirements are likely to be substantially less than this amount, but are unknown until such time as the Montana Legislature can complete a comprehensive study of school funding.
In either case, the Tax Reform Study Committee did not have adequate information regarding the additional revenue that may be needed to meet any new school funding requirements, and this greatly hampered the ability of the Committee to develop tax reform proposals, comprehensive or otherwise, that specifically took these requirements into account.

State Fiscal Condition

The 58th Legislature adjourned contemplating a June 30, 2005 general fund ending balance of about $46 million. However, during the interim the state’s fiscal position improved considerably. At their September 16, 2004 meeting, the Committee was advised that the actual fiscal 2004 ending fund balance was $135 million, and that the fiscal 2005 balance was expected to top $142 million. This latter estimate, however, did not include any growth in revenues in fiscal 2005 above those contained in HJR2 as adopted by the 2003 Legislature. If revenues were to continue growing at the rate they did in fiscal 2004, the fiscal 2005 ending fund balance could easily top $200 million.

Following that meeting, preliminary analyses indicated that the ending fund balance for the 2007 biennium could be as high as $300 million, before any increases in expenditures were taken into account.

Prior to these revelations, many on the Committee were of the opinion that the 59th Legislature would have to contend with a fairly large, on-going structural imbalance between current expenditures and revenues. Consequently, many of the Committee’s discussions and reform proposals focused on additional revenue sources that may be needed just to adequately fund existing service levels, not to mention the additional funding that may be needed to address the Court’s school funding concerns.

Clearly, the 59th Legislature will have a much brighter revenue picture to work with than that contemplated by the 58th Legislature. Still unknown, however, are the revenue requirements needed to accommodate the school funding issues raised by the Court. Depending on the final outcome of school funding matters, the dramatic turnaround in the state’s fiscal condition during the interim may relieve some of the pressure that some of the Committee members were feeling to provide new revenue sources to meet current spending levels.

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The remainder of this Executive Summary provides a brief overview of the main ideas, concepts, findings, recommendations and proposals for reform discussed by the Committee during the course of their meetings. The below summary is organized by major section heading of the main body of the final report.
School Funding

In addition to the findings in the Sherlock decision, the Committee finds the following concepts stemming from their discussions with the School Renewal Study Commission to be of importance when considering school funding:

- The current school funding system, coupled with wide disparities in property tax bases and wealth across school districts, results in wide disparities in the number of mills levied to support the BASE budgets of school districts across the state. These disparities raise issues that involve fairness in taxation, equal educational opportunity, and the ability to increase efficiencies in delivering school services through district consolidations.

- An alternative system that fully funds the BASE budgets of schools at the state level would not only eliminate the wide disparity in current taxpayer effort, but would also advance the goal of equal educational opportunity and increase the efficiency of the system by facilitating school consolidations.

- The Tax Reform Study Committee is adamant that all efforts be made to examine all options for improving and increasing efficiencies in delivering school services before additional funding needs are addressed. To this end, the Tax Reform Study Committee endorses the concept of pooled health insurance for school employees as one means of increasing efficiencies in school funding.

Evaluation of Montana's Current Tax Structure

Public input was an important component in the deliberations of the Tax Reform Study Committee; public testimony was a regularly-scheduled item on the agenda of each Committee meeting. In addition, the Committee’s second meeting was devoted entirely to public testimony on Montana’s current tax structure and options for change. The Committee’s final meeting was devoted to discussion of the Committee’s final recommendations and proposals for change, and to public comment on those proposals. Here are some of the major issues expressed by the public:

- Property taxes remain a major concern, with people testifying that the state is overly dependent on property taxes; that there is an over-reliance on property taxes to fund schools; that it is not possible for property taxes to be fairly applied over time and across geographic areas; and that the property tax system is overly complex.

- A majority of people testifying indicated that the Montana Legislature should not tamper with or alter the individual income tax provisions of Senate Bill 407 (2003 Legislative Session).
A majority of people testifying were not in favor of addressing tax reform through a piecemeal approach, but instead prefer a comprehensive approach that incorporates a general retail sales tax to provide for reductions in property and/or income taxes.

The public also wants assurances that if a sales tax is used to reduce property and income taxes, that the reductions in property and income taxes will be permanent.

The Tax Reform Study Committee also conducted their own evaluation of Montana's current tax structure in light of selected guiding principles of taxation. The Committee scored a wide variety of existing and possible new taxes, including a sales tax, on the basis of whether the tax had a favorable, unfavorable, or neutral impact on each guiding principle. The guiding principles selected by the Committee for the evaluation included equity (fairness), simplicity, reliability (which incorporates stability, certainty, and adequacy), efficiency, effect on economic behavior, exportability, and visibility.\(^1\)

Following are some of the major conclusions drawn by the Committee:

- While the Committee found most existing taxes to be fair, they were concerned with the fairness of the property tax and the insurance premiums tax. Generally, the Committee also did not feel that a pop tax or a big box store tax would be fair.

- Most taxes where found to be simple and easily understood, with the exception of the individual income tax, property tax, and oil and natural gas taxes.

- Corporation license taxes and certain natural resources taxes—oil and natural gas production taxes and the metal mines license tax—were found to be highly unreliable, contributing to instability in revenue flows.

- No tax was found to have a favorable impact on economic behavior.

- Generally, Montana does a good job when it comes to exporting taxes to nonresidents. Individual income taxes, property taxes, and corporation license taxes are all deductible for federal income tax purposes, allowing exportation via this means. Certain selective sales taxes, and many natural resource taxes are exported either indirectly in the price of commodities shipped out of state, or directly in the prices paid by nonresidents visiting the state.

### Establishing Montana's Tax Structure Baseline

In their first few meetings, Tax Reform Study Committee members noted that during recent and past legislative sessions it was often difficult to obtain definitive information on Montana's tax structure—both in terms of how the tax structure has changed over time, and in relation to neighboring states. The committee decided that in order for any discussion of tax reform to be put into context, they should establish a baseline of

\(^1\) A full description of these guiding principles can be found in the main body of the final report.
current tax structure data from which proposed changes to the structure could be gauged.

Here are the major points the Committee found with respect to Montana’s current tax structure:

**Tax Structure – Over Time**

- Montana’s total tax burden, as measured by revenue per $1,000 of personal income, dropped from $109.10 in 1980 to $102.77 in 2000. (In 1990 revenue per $1,000 of personal income was $115.51; hence, all of this drop occurred in the time period 1990 to 2000).

- Revenue per $1,000 of personal income dropped for property taxes, and dropped significantly for severance taxes from $13.12 in 1980 to just $4.11 in 2000. Revenue per $1,000 of personal income increased over this period for selective sales taxes, income taxes and other taxes.

- As a share of the total burden, Montana relied less on property and severance taxes and more on income, selective sales, and other taxes in 2000 than it did in 1980.

**Tax Structure – Comparison with Other and Neighboring States**

The Tax Reform Study Committee compared Montana’s state and local government tax structure with all states and with our immediate neighboring states (Idaho, Wyoming, North Dakota, and South Dakota) in fiscal 2002. Here are the major findings of this comparison:

- Montana is different from all states and neighboring states in that we have no general sales tax, whereas all states rely on a sales tax for 25% of their total tax revenue and our neighboring states rely on a sales tax for 27% of their tax revenue.

- Property taxes comprise a much larger share of the tax structure in Montana (43%) than in all states (28%) or in our neighboring states (30%).

- Montana’s reliance on income taxes (29%), which includes both individual and corporate income taxes, is nearly equal to that of all states (28%), but much higher than that of our neighboring states (17%). This is not surprising given that South Dakota and Wyoming have neither an individual income tax nor a corporate income tax.

- When looking at tax burden in terms of taxes per $1,000 of personal income, Montana had a slightly lower tax burden of $102.77 per $1,000 of personal income, than either all states ($103.87) or our neighbors ($103.12).
Findings By Tax Type

During the course of their deliberations, the Tax Reform Study Committee heard public testimony on and discussed many issues pertaining to the different types of existing taxes used in Montana, and on the possible use of a general retail sales tax. The following sections highlight the major points that arose during the conversations of each of these major tax types.

Property Tax

Class 8 Business Equipment "Trigger"
There was considerable debate regarding whether the Class 8 business equipment trigger, which if hit will eliminate taxes on business equipment, should be repealed. Central issues surrounding this topic include:

- Eliminating business equipment taxes will reduce revenues an estimated $67.6 million when fully phased in, with $12.1 million of this accruing to the state general fund, $48.4 million accruing to local governments and schools; and $6.4 million accruing to tax increment financing districts.

- If the trigger is hit, should the Montana Legislature reimburse local governments and schools for the revenue reduction, or should mill levies be allowed to "float" and recoup the revenue from other property classes?

- If the trigger is hit, should the Montana Legislature reimburse tax increment financing districts for the revenue reduction, or should these entities find other means of financing their bond payments?

- Eliminating taxes on Class 8 business equipment could result in litigation that seeks to eliminate property taxes on other personal property. This could result in revenue losses that far exceed those associated just with Class 8 business equipment.

- In lieu of any general decrease in the tax rate on Class 8 business equipment, should the Montana Legislature consider increasing the current law $5,000 business equipment exemption to provide small businesses with tax relief?

- In lieu of allowing the Class 8 business equipment trigger to be hit, should Class 8 property be included with Class 4 residential and commercial properties to provide insurance against future tax increases for business equipment?

Tax Increment Financing Districts
The Tax Reform Study Committee discussed tax increment financing districts on several occasions. While the Committee came to no formal recommendations or proposals regarding these economic development tools, the Montana Legislature, when deliberating and debating tax policy, may wish to take into consideration the following
issues that arose during the Tax Reform Study Committee’s discussion of tax increment financing districts:

- Comprehensive tax reform proposals that include eliminating the 95 mills currently levied statewide for the state general fund would reduce revenues to TIFs significantly, as these mills represent close to one-fifth of all revenue currently accruing to TIFs. How would this revenue be replaced in proposals of this nature?

- Why are TIFs allowed to retain revenue from the 95 mills levied statewide for state general fund purposes? Why are taxpayers in communities without TIFs subsidizing economic development in communities with TIFs? Should the 95 mills for the state general fund be exempt from future TIFs in the same manner that the statewide 6 mills levied for the University System currently are exempt? If the purpose of TIFs is for local economic development, why aren’t just the local government and school district mill levies used for this purpose, as is the case in the local property tax abatement program provided for in Title 15, Chapter 24, Part 14?

- Finally, given the impact on the mill levies of local governments and school districts, should the creation of a TIF be subject to a vote of taxpayers affected by the TIF?

Other Property Tax Issues
Property taxation of certain mines on the net proceeds basis frequently is fraught with ambiguity and uncertainty in both the definition and calculation of net proceeds. Should the Montana Legislature continue the historic general movement away from the net proceeds approach and move taxation of all mines to a gross proceeds or other less controversial approach?

Current property tax statutes provide for widely disparate treatment of similar pipeline property depending on the circumstances surrounding the operations of the pipeline. Should certain pipelines be classified uniformly as Class 8 business equipment to eliminate this disparity in treatment for tax purposes?

Should Montana’s convoluted, complex, and perhaps outdated classification system be reformed?

Natural Resource Taxes

Major issues addressing natural resource taxation included the following:

- Current statutes provide tax and other incentives for the development of new electric energy generation facilities. Some of these incentives are associated with specific sunset dates. Should these dates be extended to accommodate future development in this segment of the economy? Should specific statutory language relating to contractual obligations that must be met to receive the incentives be amended to avoid possible constitutional problems?
Should certain costs of preparing coal, such as “drying” or “washing” be excluded when calculating the tax base for the coal severance tax (contract sales price)?

Should the Montana Legislature change the manner in which production from bentonite mines and royalties received from bentonite production are taxed in order to prevent relocation of bentonite mining operations to Wyoming?

**Individual Income Tax**

Regarding the state’s individual income tax, the Tax Reform Study Committee’s discussions focused primarily on the tax reform provisions of SB407 (2003 Legislative Session). The likely issue to be debated during the 59th Legislative Assembly is whether or not the state should continue to move forward with the individual income tax reform provided for in that bill. These provisions do not take effect until January 1, 2005. Many members of the Committee believed that, given the uncertainties regarding additional revenue requirements that may be needed to satisfy the Court’s findings regarding school funding, the state cannot afford the estimated $92 million reduction in revenue stemming from SB407 in the 2007 biennium.

On the other hand, many on the Committee, and the preponderance of public testimony on the income tax, suggested that the reforms in SB407 should not be repealed. In addition, the state should continue to explore means of further simplifying and reducing individual income tax burdens to enhance the state’s business climate. Among those advocating additional reform, which could include a flat tax or possibly tying to federal taxable income or federal tax liability, there was general agreement that any additional reform would most easily be accomplished within the context of comprehensive tax reform, in which a general retail sales tax is used to reduced property and income taxes.

**Corporation License Tax**

Other than considering an increase in the corporate minimum tax, the Tax Reform Study Committee did not address the corporation license tax.

**General Retail Sales Tax**

The major topics discussed by the Tax Reform Study Committee regarding general retail sales taxes included the following:

**Regressivity**

It is generally accepted that sales taxes are regressive; although empirical studies come to different conclusions regarding the degree to which they are regressive. Regardless, the regressive nature of sales taxes must be taken into consideration when developing reform proposals that use sales tax revenue to reduce income or property taxes. How issues of regressivity are specifically addressed is a matter for continued debate and discussion. Some believe that any proposal for a sales tax must include a low-income credit or rebate of sales taxes; others find regressivity is best addressed through
appropriate exemptions from the sales tax base (food, utilities, etc.) and additional reform of income or residential property taxes, including a renter’s credit.

Streamlined Sales Tax Project
The Tax Reform Study Committee is in agreement that any sales tax adopted in Montana should make Montana a member and adopt the provisions of the Streamlined Sales Tax Project. Ultimately, this project would allow Montana, along with all other states with sales taxes, to fairly apportion among the states sales tax revenue from sales made by remote sellers (mail-order and Internet sales).

Model Sales Tax Bill
To facilitate future discussion of and debate on sales tax proposals, the Tax Reform Committee has developed for use by future legislators a “model sales tax bill.” The model sales tax is intended simply to provide interested parties with the Committee’s view on the appropriate structure of a sales tax, and is not intended to provide any direction as to how revenues from the sales tax would be used.

Furthermore, inclusion of the model sales tax in this report does not imply that all of the Tax Reform Study Committee members support or endorse implementation of a general retail sales tax. Instead, the Committee finds that inclusion of a model sales tax may be helpful to those members of the Montana Legislature wishing to pursue comprehensive tax reform proposals that include implementing a sales tax.

Comprehensive Tax Reform – Concepts and Issues

Recent Comprehensive Tax Reform Proposals

Not surprisingly, the Tax Reform Study Committee spent a great deal of time examining and discussing comprehensive tax reform. The concept of comprehensive tax reform means different things to different people. Throughout this report, comprehensive tax reform refers to proposals that would implement for the first time in Montana a broad-based consumption tax that generates revenue sufficient to provide for substantial reductions in existing income and/or property taxes. Historically, these types of reform proposals have relied predominantly on the general retail sales tax as the consumption tax component; although on occasion the Montana Legislature has considered a broad-based gross receipts tax, and even a value added tax.

Regarding comprehensive tax reform, the Committee heard and discussed a variety of approaches and concepts that have been embodied in recent comprehensive tax reform proposals. Various approaches examined by the Committee included SB258 (1997), which was sponsored by the Montana Association of Counties; MACo also provided the Committee with an update of how they would modify that bill today. The Committee also examined the provisions of bills introduced by Senator Mangan (SB470) and Representative Peterson (HB749) in the 2003 Legislative Session. Representative Ron
Erickson provided the Committee with an overview of HB765 (2003) and how that bill could be modified and updated to address current school funding and other issues.

The Committee heard and studied the various approaches taken in all of these proposals that addressed the nature of the particular sales tax used; components of each bill that addressed the regressivity of the sales tax; how sales tax revenues would be used to reduce income and property taxes; the impact that these proposals would have on school finance and other school funding issues; and how each proposal would address voter approval and/or contingent termination of the proposal.

Issues in Comprehensive Tax Reform – Net Wealth Implications

The Tax Reform Study Committee also discussed at least two major considerations in comprehensive reform that are inherent in most or all of the comprehensive reform bills that have been introduced in recent years.

The first issue addresses the resulting consequence of comprehensive reform on Montanans' net wealth. Past discussions have largely overlooked the implications of comprehensive tax reform with respect to Montanans' federal tax liabilities. Since the federal Tax Reform Act of 1986, state sales taxes have not been deductible for federal income tax purposes, but state income and property taxes have been deductible. Consequently, it is likely that using new revenue from a sales tax to significantly reduce property or income taxes will act to increase Montanans' federal income tax liabilities. Depending on how comprehensive tax reform proposals are constructed, the attending increase in federal tax liabilities may result in a net reduction in wealth for Montanans, and policymakers should be highly cognizant of this possibility.

A detailed discussion of the implications of comprehensive tax reform on Montanans' federal income tax liabilities, and on the resulting change in the net wealth position of Montanans arising from comprehensive reform is provided in the main body of this report. In general, when considering the exportability and net wealth aspects of any reform proposal, policymakers should be guided by the following general principles:

- Any reform proposal that substitutes a sales tax for individual income and/or residential property taxes will increase Montanans' total federal tax liability, thereby eroding the net wealth position of Montana taxpayers. This is because individual income and property taxes are deductible for federal individual income tax purposes, whereas sales taxes may not be. Whether this erosion results in a net increase or decrease in the net wealth position of Montanans depends on the specifics of any particular reform proposal.

- Concentrating tax relief on the residential property tax, rather than on the individual income tax, is likely to have a much smaller impact on reducing the state's exportability position and the net wealth position of Montanans. This is because residential property taxes in total are significantly less than individual income taxes; because they are distributed more toward the lower end of the income scale; and
because a much smaller proportion of taxpayers itemize deductions for federal income tax purposes at the lower end of the income scale.

- Concentrating tax relief at the lower end of the income scale, rather than at the high end of the income scale, is likely to have a much smaller impact on reducing the state's exportability position and the net wealth position of Montanans. That is because a much smaller proportion of taxpayers itemize deductions for federal income tax purposes at the lower end of the income scale.

- Concentrating tax relief on the individual income tax combined with concentrating relief at the high end of the income scale is the least optimal option vis-à-vis the state's exportability position and the net wealth position of Montanans. That is because the state individual income tax is highly progressive, with the vast majority of the tax paid by higher income households; and because a much larger proportion of higher income households itemize deductions for federal income tax purposes.

**Issues in Comprehensive Tax Reform – Property Tax Relief from State 101 Mills**

The second issue concerns recent reform proposals that provide for property tax relief by eliminating property taxes associated with state-levied mills – these include the 6 mills levied for the University System, and the 95 mills levied for the state general fund (for school equalization).

There are two approaches to providing tax relief from these mills. The first approach would simply repeal these mills, reducing all property taxpayers' liabilities by 101 mills, or by $180-190 million, annually.

Under the second approach, taxpayers would be allowed a refundable tax credit against income tax for the amount of property tax associated with the 101 mills, prorated by the ratio of the taxpayer's Montana-source income to total income. This approach reduces revenues an estimated $120-130 million, annually.

Under the first approach, all taxpayers would be relieved of the total tax bill associated with the 101 mills. Under the second approach, taxpayers would be relieved of this portion of their total property tax bill only by the extent of the ratio of their Montana income to their total income. Under the credit approach, taxpayers would continue to pay about $60 million per year more in taxes than if the mills were repealed entirely. While some of this would be paid by nonresident homeowners with little or no income in Montana, the majority of this difference would be paid by large, multi-state corporations, particularly utility companies, with significant in-state property holdings that derive a just a portion of their total income from Montana sources.

The advantages and disadvantages to these two approaches are discussed in detail in the main body of this report.
Committee Recommendations and Tax Reform Proposals

The Tax Reform Study Committee did not formally vote on any specific proposals or recommendations to provide for tax reform in Montana. The committee agreed that there are many options and approaches to reforming the state's tax structure, and that it would be appropriate for the committee to provide the Montana Legislature with a menu of the various proposals and recommendations that were discussed during the course of the Committee's deliberations.

The Tax Reform Study Committee also wishes to make it clear that not all members of the Committee agree with or support all of the proposals presented in this report. As with individual members of the Montana Legislature, and individual taxpayers or business organizations, there are proposals that individual members of the Committee agree with and support, and there are proposals that individual members of the Committee do not agree with or support.

To address the issues discussed in previous sections, the specific proposals and recommendations discussed by the Tax Reform Study Committee are categorized into the following three general groups:

Comprehensive Tax Reform

The Tax Reform Study Committee advanced one comprehensive tax reform proposal, sponsored by Representative Peterson and Professor Myles Watts. That proposal includes the following general components, which are discussed in detail in the recommendations and proposals section of the report:

- a 4% general retail sales tax based on the Model Sales Tax Bill provided by the Tax Reform Study Committee;
- reform of the individual income tax by providing for a flat 5.75% tax rate, increasing the personal exemption, eliminating the current law deduction for federal income taxes paid during the year, and providing for an exclusion of 50% of capital gains income from tax;
- fully funding the BASE budgets of schools with sales tax revenue, thereby reducing property taxes an average of 63 mills statewide;
- providing for further property tax relief by repealing the 101 mills levied for state purposes.

The property tax changes in this proposal take effect January 1, 2005; the sales tax would take effect January 1, 2006; and the individual income tax reform would take effect January 1, 2007. The proposal would terminate December 31, 2009 if not continued by a vote of the electorate in November 2008.
Tax Reform Proposals Providing for Revenue Enhancement

The following proposals, discussed in detail in the recommendations and proposals section of the main body of this report, provide the Montana Legislature with options to enhance revenue either by repealing existing statutes that substantially reduce revenue in coming years, or by providing for additional revenue from new or existing sources:

- repeal the current law Class 8 business equipment tax "trigger";
- repeal the individual income tax provisions of SB407 (2003 Legislative Session);
- implement a soft drink ("pop") tax;
- implement a gross receipts ("big box store") tax;
- increase current law gambling taxes; and
- increase the current law corporation minimum tax.

Tax Reform Proposals Addressing Specific Issues

The following proposals, discussed in detail in the recommendations and proposals section of the main body of this report, provide the Montana Legislature with proposals that address particular concerns heard by the Committee that are limited in scope, and address specific sections of the tax code; some address matters currently in litigation. All of these concerns involve property taxes, natural resource taxes, or a combination of these two taxes.

- revise and modernize Montana's property classification system to make it more fair and less complex;
- increase the current law $5,000 exemption for Class 8 business equipment;
- revise the current classification and taxation of pipeline property to address current litigation issues;
- exempt pollution control equipment from property tax;
- provide for a new method of taxing bentonite mines and royalties from bentonite production;
- exempt certain processing costs for coal severance tax purposes;
- extend certain tax incentive termination dates for new electric energy generation facilities;
- address certain legal and other issues pertaining to current coal severance tax incentives.
Section 1

Tax Reform Study Committee

Genesis, Charge and Membership
Tax Reform Study Committee – Genesis, Charge and Membership

The Tax Reform Study Committee was created in Senate Bill 461, enacted by the 58th Legislature. That bill provided that the purpose of the committee is to conduct a comprehensive examination of taxation in Montana. Specifically, the committee was charged with:

- developing an inventory of taxes imposed at the state and local level;
- providing analyses that evaluate existing taxes in terms of their generally accepted principles of a high quality revenue system, to include: adequacy, efficiency, burden or incidence, fairness, exportability, impact on the economic behavior of both individuals and businesses, and costs of administration and compliance;
- examining current "tax expenditures" in order to assess the ongoing merit of each expenditure; and
- examining alternative methods of taxation from existing as well as new sources of revenue, and evaluating these methods in terms of the criteria listed above.

The Tax Reform Study Committee was to solicit the knowledge and advise of economists, tax policy experts, and representatives of taxpayer groups, local governments, small business organizations, large industry, agriculture, and economic and business development organizations.

The Tax Reform Study Committee is required to submit a written report to the Legislature by December 1, 2004 that must include recommendations for tax reform and, if required, proposed legislation designed to accommodate those recommendations.

SB461 also created the interim Property Tax Reappraisal Study Committee, which was charged with studying the effects of cyclical reappraisal and methods for mitigating the changes in taxable value caused by cyclical reappraisal. The Tax Reform Study Committee was required to coordinate their work with the Property Tax Reappraisal Study Committee, and the two committees were required to meet in joint sessions at least once every 6 months. During the interim, the two committees met twice in joint session.

The Tax Reform Study Committee was comprised of four Senators, two from each political party, appointed by the Committee on Committees; four Representatives, two appointed by the Speaker of the House and two appointed by the Minority Leader; and four members appointed by the Governor specifically to represent small business, large industry, agriculture, and labor.
Committee Members

Senator Keith Bales (Presiding Officer)  Representative Eileen Carney
Senator Jon Ellingson  Representative Jill Cohenour
Senator Dan Harrington  Representative Bob Lake
Senator Gary Perry  Representative Jim Peterson

Mary Whittinghill, President, Montana Taxpayer's Association (Small Business)
Ken Morrison, Lobbyist, PPL Montana, Inc. (Large Industry)
Myles Watts, Professor, Department of Agricultural Economics and Economics,
Montana State University (Agriculture)
Jerry Driscoll, Executive Secretary, Montana AFL-CIO (Labor)

Committee Meetings

The Tax Reform Study Committee met a total of 11 times over the course of the interim at the following times and locations:

<table>
<thead>
<tr>
<th>Meeting</th>
<th>Date</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meeting 1</td>
<td>September 12, 2003*</td>
<td>MACo Conference Room, Helena</td>
</tr>
<tr>
<td>Meeting 2</td>
<td>October 14, 2003</td>
<td>MACo Conference Room, Helena</td>
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<tr>
<td>Meeting 3</td>
<td>November 12, 2003</td>
<td>MACo Conference Room, Helena</td>
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<tr>
<td>Meeting 4*</td>
<td>January 12-13, 2004</td>
<td>Room 317, State Capitol Bldg., Helena</td>
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<td>Meeting 5</td>
<td>February 19-20, 2004</td>
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<td>Meeting 6</td>
<td>March 25-26, 2004</td>
<td>MACo Conference Room, Helena</td>
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<td>Meeting 7**</td>
<td>May 6-7, 2004</td>
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<td>Meeting 8</td>
<td>June 14-15, 2004</td>
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<td>July 12-13, 2004</td>
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<td>Meeting 10</td>
<td>August 9-10, 2004</td>
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<td>Meeting 11</td>
<td>September 16-17, 2004</td>
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Section 2

School Funding
School Funding

Sherlock Decision

On April 15, 2004, Judge Jeffrey Sherlock, Montana 1st Judicial District Court, issued a decision in the matter of Columbia Falls Elementary District, et. al. v. State of Montana. In essence, Judge Sherlock found that Montana's current system of funding schools violates state constitutional provisions pertaining to school funding.

Montana's Constitution specifically provides that:

- Equality of educational opportunity is guaranteed to each person of the state.
- The Montana Legislature shall provide a basic system of free quality public elementary and secondary schools.
- It [the Montana Legislature] shall fund and distribute in an equitable manner to the school districts the state's share of the cost of the basic elementary and secondary school system.

Among other things, Judge Sherlock found that the current system of school funding violates the Constitution in that:

- it fails to provide adequate funding for Montana's public schools (see Findings of Fact #160), and
- the state is not paying its share of the cost of the basic elementary and secondary education.

With respect to both adequacy of funding and the state's share, Judge Sherlock in suggesting remedies, found that:

A particular requirement is that the funding system must be based on educationally-relevant factors. This requires that the funding system be based on the costs of meeting the standards that govern the operation of Montana's schools. Once adequate levels of funding are determined, the State must then fund its share of the cost of the system. The State's share must be an amount that is adequate at the BASE or foundation levels to allow districts to meet the standards. As previously established, this applies not only to general funds, but to the overall costs of the elementary and secondary system.

At a minimum, this implies that adequacy of funding should be based on a thorough and unbiased cost analysis of what is required in the way of funding to meet the state's
accreditation standards. Unfortunately, this study has never been done. In addition, Judge Sherlock reinforced the finding in a previous court case (Helena Elementary I) that "...the Montana School Accreditation Standards do not fully define either the constitutional rights of students or the constitutional responsibilities of the State of Montana for funding its public elementary and secondary schools." This implies that fully funding the accreditation standards alone may not satisfy the constitutional requirement of providing a quality education, but that factors other than the accreditation standards may also have to be taken into consideration and require funding.

Finally, Judge Sherlock noted that the findings in his decision were to be stayed until such time as the matters were resolved by the Montana Supreme Court. In addition, he provided that, unless otherwise ordered by the Supreme Court, the findings in the decision were not to take effect until October 1, 2005 giving the Montana Legislature time to address the very complicated and difficult issues involved in the case.

Judge Sherlock's decision was subsequently appealed to the Montana Supreme Court. On November 8, 2004, that Court issued a preliminary order that generally upheld the findings of the lower court. Specifically, the Supreme Court concurred that:

- the current school funding system is not based on educationally-relevant factors;
- furthermore, until such time as the Legislature assesses education needs and defines "quality", it is not in a position to construct a funding system rationally related to educationally-relevant factors;
- for these reasons, the current funding system fails to adequately fund Montana's public schools; and
- the state has failed to recognize the distinct and unique cultural heritage of American Indians and has shown no commitment in its education goals to the preservation of Indian cultural identity.

The Supreme Court declined to immediately address whether the state's share of school funding is appropriate, and affirmed the District Court's selection of October 1, 2005 as the effective date of its order.

**Interim School Renewal Study Commission**

Independent of the Sherlock decision, the Montana Legislature established the interim School Renewal Study Commission to examine the needs of Montana schools and make recommendations addressing all aspects of education in Montana; this included many of the same types of issues addressed in the Sherlock decision.

The Tax Reform Study Committee met several times with members of the School Renewal Study Commission in order to understand the issues surrounding school funding and gain insight into what might be done from the taxation perspective to address certain school funding issues.
Of significant concern for the School Renewal Study Commission was the wide disparity in property tax effort required to fund education across school districts. Members of the School Renewal Study Commission testified that the disparity in local mills levied to fund the BASE portion of school districts ranges from 0 to 96 mills. School districts in areas with very low property wealth are already levying a large number of mills, making it very difficult in some areas to pass additional mill levies, even to get the district above the 80% BASE budget level of funding. Districts with high property wealth can pass relatively low mill levies to attain funding at 100% of the maximum general fund budget, and that leads to disparity not only in taxation but also in spending per pupil.\(^1\)

This disparity, a consequence of the current school funding formula, not only raises issues of equity with respect to taxpayers, but also inhibits consolidation efforts that could lead to added efficiencies in the overall system. A system that fully funds the BASE budget of schools at the state level would not only eliminate the wide disparity in current taxpayer effort, but would also facilitate school district consolidations, as local property taxpayers would no longer be worried about potentially large additional property tax mill levies arising as a consequence of consolidating with a low-wealth, tax-poor district.

The question then becomes one of how the state should fully fund the BASE budgets of schools in order to eliminate, or at least alleviate, these disparities. The School Renewal Study Commission had considered a couple of options, including simply increasing the current statewide school equalization levy of 95 mills an additional 70 mills. This option was viewed by the Commission as not being politically viable as it would place substantial additional tax burdens on large commercial properties, agriculture and other segments of the economy. Another option would be to remove dense concentrations of property value, such as centrally assessed properties, mines, and power plants, from local property tax bases, tax these properties at the state level, and redistribute the funds on a formula basis. This gets more complicated as the state would then have to reimburse county and city governments as well as school districts for the reduction in local tax base. This approach may raise constitutional concerns as well. Other options include looking at new revenue from natural resources, the coal tax trust, a sales tax, or other sources.

Members of the Tax Reform Study Committee expressed their concerns that the School Renewal Study Commission fully examine all options for improving and increasing efficiencies in delivering school services. School Renewal Study Commission members indicated that a "regionalization" working group was working on those types of issues, and was examining regional delivery models currently being used in peer states. Commission members expressed confidence that efficiencies would arise as a natural consequence of a more regionalized delivery system, accommodated by a new taxing scheme that significantly reduces or eliminates the current disparities in tax efforts across school districts. Commission members also indicated that the regionalization

\(^1\) Note that in the Sherlock decision the plaintiffs did not prevail in their argument that these wide disparities in property tax efforts required to fund education across school districts preclude equal educational opportunities across school districts.
working group had developed about a dozen recommendations for changes to current law that could make consolidation of districts easier. It was also noted that a complete analysis of the costs savings from consolidation would be very difficult to do.

School Renewal Study Commission members also stressed that efficiencies should be obtained by allowing taxpayers and parents to maintain local control, and make decisions based more on educationally-relevant factors rather than on tax factors, provided a revenue source could be found to fully fund school districts at the BASE level.

The School Renewal Study Commission also created a "parking lot" where recommendations for improving the quality of public education would be placed for discussion and final approval. Commission members at one point indicated at least 13 items had been placed in the parking lot, including a recommendation to allow full time kindergarten. The cost of implementing these quality items would be in addition to the costs associated with meeting basic accreditation standards. The commission indicated they were in the process of costing out those items of quality.

After voting on the matter, the Tax Reform Study Committee sent a letter to the interim Education and Local Government Committee endorsing the concept of pooled health insurance for school employees as one means of increasing efficiencies in school funding. Statewide health insurance was also one of the items of quality placed in the "parking lot" by the School Renewal Study Commission.

Finally, the Tax Reform Study Committee spent a significant amount of time learning about school finance through a presentation provided by Jim Standaert of the Legislative Fiscal Division.

**School Funding and Comprehensive Tax Reform**

During the course of their deliberations, the Tax Reform Study Committee was never apprised of the potential costs of bringing the school funding system into compliance with the findings in Judge Sherlock's decision, including the costs associated with the "quality items" included in the School Renewal Study Commission's "parking lot." Obviously, uncertainties of this importance and magnitude severely hampered the Tax Reform Study Committee's ability to discuss and devise a comprehensive tax reform proposal that could take these costs into consideration.

Consequently, the Tax Reform Study Committee did not spend a great deal of time directly discussing alternative approaches to increasing the state's share of total school funding, or additional revenue sources that could be used to provide additional funds to meet the adequacy requirement inherent in the district court decision.

The only proposal from Tax Reform Study Committee members that specifically addressed school funding issues directly was Representative Peterson's proposal to
implement a general retail sales tax, and use a portion of the revenue to fully fund the BASE budgets of school districts at the state level. Among other things, this proposal also provided for eliminating the existing 95-mill statewide levy for school equalization, and the 6-mill statewide levy for University System funding, thereby removing the state from the property tax business altogether. Fully funding the BASE budgets of schools at the state level not only addresses the state share of school funding issue raised in the Sherlock decision, but also eliminates the wide disparity in mills currently being levied at the local level for schools' BASE budgets.

Legislators have asked the Legislative Fiscal Division to examine means of developing a comprehensive school funding study that would address costs associated with meeting the state's accreditation standards, and other educationally relevant factors. The Tax Reform Study Committee also sent a letter to the Legislative Fiscal Division requesting that such a study be undertaken. It is likely that the Legislative Fiscal Division, working with a variety of education associations, will commission a study from an independent source to begin prior to the 2005 Legislative Session. It is unclear at this time just when the final results of such a study would be available to the Montana Legislature. But clearly, the results and implications of such a study will play a crucial role in whatever decision the Montana Legislature ultimately makes regarding comprehensive or partial tax reform.
Section 3

Evaluating Montana’s Current Tax Structure
Evaluation of Montana’s Current Tax Structure

The Tax Reform Study Committee spent considerable time examining and evaluating Montana’s current tax structure. The committee’s first meeting was dedicated to a strategic management planning session that allowed committee members to brainstorm perceived problems and issues surrounding the state’s current tax structure, and impediments to achieving significant tax reform.

The Tax Reform Study Committee’s second meeting, and much of their final meeting, was devoted entirely to public testimony, during which the committee heard many issues and concerns expressed by those wishing to testify. The committee also received a substantial amount of written correspondence in which the general public expressed their concerns regarding the current tax structure, as well as their opinions regarding where the state should focus tax reform efforts.

Finally, the Tax Reform Study Committee completed a formal evaluation of most current taxes, and some proposed taxes, in light of the guiding principles criteria defined in the committee’s charge. The central points and highlights of oral and written public testimony heard and received by the committee, and the results of the committee’s formal evaluation of current and proposed taxes are provided in the following sections.

Public Testimony

Public input was an important component in the deliberations of the Tax Reform Study Committee. Montanans were asked to bring forward their concerns and ideas on Montana’s tax system and potential reform. The second meeting of the Tax Reform Study Committee was devoted entirely to public testimony. Prior to that meeting, the committee asked the general public to provide testimony that specifically addressed the following four questions:

- How do you view the current state and local government tax system?
- What changes would you recommend to Montana’s current tax system?
- If your recommendations were to result in more/less revenue, where would you increase/decrease state and/or local government expenditures?
- How receptive do you feel the general public would be towards your proposal for change?

In addition, the final meeting of the Tax Reform Study Committee was devoted to presentation of the committee’s final proposals and recommendations for tax reform and to public testimony regarding those proposals and recommendations.
More than one hundred citizens responded to the Tax Reform Study Committee’s request for input either through oral or written testimony. Representative testimony regarding specific issues included the following:

**Tax Reform.** The overwhelming theme of the public comments was for the Montana Legislature to provide for broad-based, comprehensive tax reform in which a general retail sales tax is used to provide for property and income tax relief. Of the 63 people testifying on tax reform, 59 favored a sales tax while four were against a sales tax. Those testifying in favor of a sales tax were also in favor of significant property tax relief (88%) or income tax reductions (56%).

**School Funding.** People were concerned about the level of property taxes that are used to fund schools. They believed reform was needed to reduce the reliance on property taxes for school funding and to address the differences in mill levies throughout the state.

**Tax Creep.** In addition, there was concern that if tax reform is achieved with reductions in some taxes, there must be assurance that those taxes won’t return to their former levels. This assurance could be in the form of legislated tax caps or constitutional amendments.

**SB407.** There was specific testimony regarding the provisions of SB407 (2003 Legislative Session) that implement income tax reductions beginning in tax year 2005. Of the 11 people testifying on SB407, nine testified it would be a mistake to repeal the reform and two thought the reforms should be overturned.

**Principles of Taxation.** People also addressed the guiding principles of taxation. The major suggestions were that our tax system needs to be simplified, balanced, competitive and equitable.

**Selective Sales Taxes.** Generally, people were not in favor of additional selective sales taxes such as a pop tax or a gross receipts big box store tax. Specifically, 70 percent were opposed to a big box store tax, and nearly the same (66 percent) were in opposition to a pop tax. Six people favored increases in gaming taxes.

**Other Specific Comments and Suggestions**

Oral and written testimony included the following additional specific public comments:

- The state is overly dependent on property taxes as a primary source of revenue.
- It is not possible for property taxes to be fairly and equitably applied over time and across geographic areas.
- Montanans leave large amounts of money on the table by paying sales taxes to other states when they visit them, and by not charging out-of-state visitors sales taxes when they visit here.
Sales taxes are “bad medicine.” Sales taxes are not deductible on our federal or Montana tax returns. The sales tax creates hundreds of new tax collectors and a paperwork blizzard. Sales taxes are complex and very sensitive to political pressures. There is no guarantee that current or future legislators would not raise property taxes.

Tax reform can mean cleaning out the accumulated provisions in tax code for special interests and treating all taxpayers more alike; cleaning out particularly punitive provisions in code which suppress work and investment and private job creation and economic development; finding ways to make the tax burden hit most everyone to some reasonable degree and making the collection of tax revenue less costly to both government and the taxpayer.

Tax reform should first recognize that essential services are necessary and taxes are necessary to fund those services. The practice should be to determine what services are necessary and at what level. Then taxes should be set accordingly. If tax reform proponents do not concede that tax reform will result in increased taxes for some taxpayers, it will fail.

We believe that Montana should adequately fund human services, K-12 and higher education. To do so at this point would require more revenue. We believe people in Montana want these services; we believe the people of Montana want to pay for these services through a fair and balanced tax system.

As we review our tax system over time, we can’t overlook the impact from the loss of revenue resulting from the decisions made to reduce and stop the harvest of natural resources.

New revenue is needed if the Montana economy is to prosper. This might be in the form of a new tax that would spread the payment over a larger group of citizens.

Montanans are getting older faster than the national average. A pop tax would backfill the cuts that had to be made in the aging services budget in the Department of Public Health and Human Services. It will fund the 500 seniors on the waiting list for home and community based care, and it will create an Older Montanan Trust Fund with one half of the proceeds generated each year.

Montana’s property tax system is often viewed as both complex and imbalanced. Contributing to this is the system of classifying properties. There are 11 classes of property with taxable value rates ranging from 3 percent to 100 percent.

Pass a resolution encouraging the 2005 Montana Legislature to implement a budget process that clearly identifies the costs of all programs and services currently provided, accurately reflects the costs associated with base level adjustments, and adopts principles or policies that help allocate monetary and other resources to the government services that are desired by the citizens of Montana.

Mineral taxation in Montana is complicated and not competitive with surrounding states. Some incentives scheduled to expire should be extended.

Consider increasing the Class 8 business equipment exemption ceiling from $5,000 to $25,000 for small businesses as part of any tax reform proposal.

Eliminate property taxes on equipment that significantly reduces emissions. This will create an incentive for business to maintain existing equipment and make capital investments in new pollution control equipment.
Evaluation of Selected Current and Proposed Taxes

Senate Bill 461 specifically charged the Tax Reform Study Committee with providing analyses that evaluate existing taxes in terms of the generally accepted principles of a high quality revenue system, including adequacy, efficiency, burden or incidence, fairness, exportability, impact on the economic behavior of both individuals and businesses, and costs of administration and compliance.

On several different occasions the Tax Reform Study Committee discussed approaches of how to best meet this requirement of the bill. It was noted that a complete and thorough evaluation of Montana's current tax structure would likely require all of the time available to the committee, and that an abbreviated approach would be needed to allow time for other committee work.

The Tax Reform Study Committee also concluded that the specific evaluation criteria in SB461 were not necessarily the best criteria to use for evaluating individual taxes. For example, it is apparent that when evaluating taxes on the basis of adequacy that no tax by itself is adequate, when adequacy is defined as the total amount of taxes needed to fund desired service levels. Adequacy, stability, and certainty were all included under the general principle of reliability. The committee also did not include "burden or incidence" in their evaluation criteria as it was not certain just what this implied, or if there would be sufficient time to fully analyze comparative tax burdens and the underlying incidence of each tax. Besides, the appropriate level of current burdens and taxpayer incidence is implied in the general principle of equity (fairness).

With respect to burden, the Tax Reform Study Committee was provided with a comparison of state and local tax rates across western states for a wide variety of taxes including: beer, wine, and liquor taxes; cigarette and other tobacco product taxes; accommodations taxes; rental car taxes; corporation taxes; general sales taxes; electric energy taxes; video gaming taxes; metal mines taxes; natural gas and oil production taxes (new production in particular); and coal production taxes (severance, gross proceeds, and other taxes).

In the end, the Tax Reform Study Committee decided that individual taxes should be evaluated on the basis of equity (fairness), simplicity, reliability, efficiency, the effect they have on economic behavior, the degree to which they are exportable, and the degree to which they are visible. Furthermore, some of the taxes that have been proposed in past sessions (pop tax, "big box store" tax, general retail sales tax) would be evaluated along with existing taxes. Following are brief descriptions of the evaluation criteria used by the committee.

Equity (Fairness). Highly subjective, fairness is concerned with the variations in tax incidence and tax burdens faced by different individuals and businesses. It is complicated in that it involves the "benefits" and "ability-to-pay" principles of taxation; horizontal and vertical equity; and the concepts of progressivity and regressivity.
The benefits principle considers a tax fair if the benefits received from the government service supported by the tax are commensurate with the tax or fee charged each person for the service. The ability-to-pay principle asserts that taxes should be levied based on the taxpayer's ability to pay, as measured by some indicator of economic well being such as income. Within the ability-to-pay principle, the notion of horizontal equity suggests that taxpayers and households that are similarly situated should shoulder a similar burden of taxes.

The concept of vertical equity addresses fairness in taxation of taxpayers in different economic situations, and involves the progressivity or regressivity of taxes. Some people believe that equity is satisfied under a system in which all taxpayers pay the same percentage of their incomes in taxes (proportional tax structure), while others believe that equal sacrifice requires that higher income households pay a larger percentage of their incomes in taxes as incomes rise (progressive tax structure). The progressivity or regressivity of the overall tax system may be more important than the progressivity or regressivity of any single tax.

**Simplicity.** Tax systems should be simple for taxpayers to understand and easy for tax officials to administer. A tax system that is simple to understand promotes and enhances taxpayer compliance, leading to a system that is also fairer. Tax systems that are easy to administer reduce administration costs and enhance the efficiency of the overall system. Frequently, simplicity may be sacrificed in order to enhance the overall fairness of the system. With respect to businesses, coordinating taxing efforts between state, local, and tribal governments, and other “one-stop shopping efforts,” can lead to reduced costs of compliance.

**Reliability.** Reliability encompasses the notions of stability, certainty, and adequacy. Stability refers to the ability of the tax system to provide a relatively constant flow of revenue over time regardless of fluctuations in the state's population or economy. Generally, stability is achieved through a mix of taxes, some of which display more stability over time than others. Certainty refers to the extent to which tax rates, tax bases and tax types change over time. Individuals and businesses require certainty in a tax structure in order to plan effectively. Adequacy refers to the ability of the tax system to grow revenue over time commensurate with growth in population, inflation and the general economy. A tax system that is adequate provides for growth in revenues commensurate with growth in governmental expenditures without producing either excessive or insufficient revenues.

**Efficiency.** Generally, the literature on the guiding principles of taxation does not discuss efficiency as a separate or stand alone item. It is frequently discussed in conjunction with other facets such as simplicity and economic neutrality. Generally, efficiency means that the entire system of implementing, administering, paying and collecting taxes is done at minimal societal cost. Making the tax structure simple and easy to administer for both the taxpayer and the tax administrator increases the efficiency of the system, as a smaller share of total tax collections is used to pay for the costs of administration. Uniform administration, one-stop shopping programs and other
administrative features designed to reduce taxpayer compliance and administration costs all act to enhance efficiency.

**Effect on Economic Behavior.** The phrase “effect on economic behavior” encompasses a variety of concerns. First, to enhance and maintain economic vitality, a state’s tax structure should foster a climate conducive to economic development and should not unduly impede businesses from locating in the state. In this regard, neither the state’s tax structure as a whole, nor individual elements of that structure, should provide for a competitive disadvantage with tax structures of other (particularly neighboring) states, regardless of whether that disadvantage is perceived or real. Second, to as great an extent as possible business decisions should be based on economic considerations other than tax implications. Finally, a state’s tax structure should provide a level playing field, ensuring similar treatment for all industries, and for individual firms within a given industry, across the state.

**Exportability.** Exportability refers to the extent to which Montana’s taxes are paid for by nonresidents. There are several means by which taxes may be exported. First, taxes may be included in the prices of commodities exported out of state and purchased by nonresidents (for example, coal severance taxes). Second, taxes may be included in the prices of products purchased directly by nonresidents while visiting the state (for example, accommodations taxes). And finally, state taxes are exported when they can be deducted for federal income tax purposes.

**Visibility.** Also referred to as transparency, visibility refers to the extent to which taxes and the tax structure are readily apparent and obvious to taxpayers and other citizens. Taxes should be visible and easily understood; taxes should not be “hidden” whenever possible. Requiring sales and utility taxes to be displayed on customers’ bills, or displaying the tax component in prices of gasoline at the pumps, act to enhance visibility in the system.

* * * * * * * * * *

After gaining an understanding of the concepts embodied in the guiding principles of taxation, and after studying information pertaining to the various types of taxes in use in the state, the Tax Reform Study Committee formally evaluated 21 different current and proposed taxes. The procedure used was similar to one developed previously in Minnesota. For each tax type, committee members were provided with a scoring sheet that allowed them to indicate whether the tax in question had a favorable, an unfavorable, or a neutral impact on each of the guiding principles used in the evaluation process. These scoring sheets were then tabulated to determine the overall view of the committee with respect to each guiding principle for each tax type.

The results of the Tax Reform Study Committee’s evaluation are summarized in the following color-coded chart. A color coding of green indicates an overall favorable ranking, yellow indicates an overall neutral ranking, and red indicates an overall unfavorable ranking. Committee scoring is indicated by the sequence of numbers in
each cell of the table, which indicate the number of favorable, unfavorable, or neutral votes, respectively. For example, for the individual income tax, for the guiding principle of simplicity, the committee cast no votes indicating this tax is simple, cast 11 votes indicating this tax is not simple, and cast no neutral votes.

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<thead>
<tr>
<th>Tax Type</th>
<th>Equitable</th>
<th>Simple</th>
<th>Reliable</th>
<th>Efficient</th>
<th>Economic Behavior</th>
<th>Exportability</th>
<th>Visible</th>
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<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>13 Metal Mines License Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>14 Metal Mines Gross Proceeds</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>15 Elec. Energy Production Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>16 Wholesale Energy Trans. Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>17 Pop Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>18 General Retail Sales Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>19 &quot;Big Box&quot; Store Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>20 Gasoline Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
<tr>
<td>21 Video Gaming Tax</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>5,5,1</td>
<td>2,3,6</td>
<td>3,5</td>
<td>3,5</td>
<td>3,5</td>
</tr>
</tbody>
</table>

Note: Numerical scoring for each tax for each principle is in favorable, unfavorable, neutral order. For example, for the individual income tax, for equitable, the committee scored 5 favorable votes, 6 unfavorable votes, and no neutral votes.

Following sections provide a brief overview of the Tax Reform Study Committee's findings. These sections focus on the concerns found in the committee's evaluation, but note some favorable outcomes as well.
Equity

While finding most of the taxes examined generally to be fair, the Tax Reform Study Committee is obviously concerned with the fairness of the property tax and the insurance premiums tax. The committee was split on the individual income tax, cigarette and tobacco taxes, and the general retail sales tax. The committee also found that two taxes not a part of our current tax structure – the "pop tax" and the "big box store tax" – are not equitable.

Simplicity

Individual income, property, and oil and natural gas production taxes generally were not considered to be simple; the committee was nearly split on the corporation license tax; and the remaining taxes were generally found to be simple.

Reliability

The committee found the corporation license tax to be unreliable – a history of annual collections from this tax would certainly suggest this to be correct. The committee also found certain natural resource taxes – the oil and natural gas production tax and metal mines taxes – to be unreliable. The committee was split on the reliability of the individual income tax and cigarette taxes; and the committee found the remaining taxes to be reliable.

Efficiency

Collectively, the Tax Reform Study Committee appears to be greatly concerned with the efficiency of the individual income tax and the property tax; some on the committee were also concerned about the efficiency of beer, wine, and liquor taxes. The remaining taxes were generally found to be efficient.

Effect on Economic Behavior

Interestingly, no tax was found to have a favorable impact on economic behavior. The Tax Reform Study Committee appeared to be especially concerned with the impact on economic behavior of the property tax, cigarette and tobacco taxes, the insurance premiums tax, several natural resource taxes, and the pop tax. It's not clear what these concerns might be; and, generally, many of the committee members were neutral with respect to this principle for most of the taxes.

Exportability

As discussed above, taxes are exported in one of two general ways: either through deductibility of the tax at the federal level, or through payment of the taxes, either directly or indirectly, by nonresidents. Taxes that are deductible for federal purposes generally are considered to be exportable. Nevertheless, the Tax Reform Study
Committee was split on the exportability of the individual income tax, notwithstanding the fact that it can be deducted for federal tax purposes. On the other hand, the committee found property taxes and corporation license taxes to be exportable, ostensibly for this same reason.

The Tax Reform Study Committee was neutral regarding the exportability of beer, wine, and liquor taxes, even though these items generally are consumed in large part by tourists. States contemplating selective sales taxes aimed at tourists nearly always include these items in their "tourist" taxes along with meals in restaurants, rental cars, and accommodations. The committee found rental car and accommodations taxes to be exportable, ostensibly because they are consumed in large part by tourists. The committee found cigarette and insurance premiums taxes to be non-exportable.

The Tax Reform Study Committee also found all natural resource taxes (coal, oil, gas, etc.), the general retail sales tax, the "big box store tax," the gasoline tax and the video gaming tax to be exportable.

Visibility

Visibility usually refers to whether or not the tax is clearly visible to and understood by the ultimate consumer of taxed goods and services, or clearly visible to the taxpayer when they write a check to make their tax payments.

General retail sales taxes, for example, are highly visible because they are printed on the sales receipt. The committee agreed.

Individual income taxes and property taxes are highly visible because taxpayers must fill out forms detailing exactly what their liability is, or receive a bill showing exactly what their liability is. The committee found both of these taxes to be visible.

Accommodations taxes and telecommunications taxes are clearly stated on the consumers bill; ostensibly for this reason these taxes were found to be highly visible as well.

Corporation license taxes are clearly visible to the corporations that pay the tax, but to the extent that these taxes are shifted forward onto consumers of goods and services produced by corporations they are invisible to the ultimate consumer. Nevertheless, the Tax Reform Study Committee found corporation taxes to be highly visible.

The committee found cigarette and tobacco taxes, and the "pop tax" concept to be highly visible, but found beer, wine, and liquor taxes to be not visible, notwithstanding the fact that for all of these products taxpayers have no direct indication of what the tax is.

Generally, natural resource taxes were found not to be visible, as was the "big box store tax" and the video gaming tax.
Establishing Montana's Tax Structure Baseline
Establishing Montana’s Tax Structure Baseline

In their first few meetings, Tax Reform Study Committee members noted that during recent and past legislative sessions it was often difficult to obtain definitive information on Montana’s tax structure — both in terms of how the tax structure has changed over time, and in relation to neighboring states. The committee decided that in order for any discussion of tax reform to be put into context, they should establish a baseline of current tax structure data from which proposed changes to the structure could be gauged.

A sub-committee was appointed to develop the baseline information. It was decided that data from the US Bureau of the Census would be used to construct the baseline, as that source of information was generally recognized as the most comprehensive and most used information by all states when making tax structure comparisons. This section of the report presents the findings of the sub-committee regarding the tax structure baseline.

Revenue Categories

The Census Bureau annually provides information on several different categories of total state and local government revenues, including the following:

Total revenue includes non-general and general revenues.

Non-general revenue includes the gross revenue of liquor enterprises; gross revenue from government utility operations; contributions to public employee retirement funds, unemployment insurance funds and other social insurance trust funds; and investment earnings of these trust funds.

General revenue is divided into intergovernmental revenue (federal transfers), current charges, miscellaneous general revenue, and taxes. Own-source general revenue consists of all general revenue other than federal transfers.

Federal transfers are the only intergovernmental revenue for the combined state and local government sector. They include federal funds for education; federal payments for state administration of unemployment compensation systems and related services; federal aid to local governments; payments in lieu of taxes; federal aid to local health programs; federal payments for highways and transportation systems; federal aid to agriculture and natural resource programs; and federal aid for local utility systems.
Current charges includes tuition and fees charged by schools and higher education institutions; charges of publicly-owned hospitals; highway tolls and parking fees; receipts from sales of minerals or products from public lands; laboratory fees; rent from public housing; and sewer and solid waste disposal fees.

Miscellaneous general revenue includes assessments of special improvement districts; receipts from the sale of property; interest earnings; fines and other penalties; rents, royalties and donations; and net lottery revenue.

Taxes are measured as gross collections less refunds and amounts paid under protest. Assessments for special improvement districts are not counted as taxes.

The Tax Reform Study Committee examined changes over time to all of the above categories of revenue for Montana. However, because the charge of the committee was to examine Montana's tax structure, this section focuses primarily on the taxes component. For pertinent information on other aspects of Montana's overall finances, see the section below on "other observations."

**Tax Structure – Over Time**

The Tax Reform Study Committee examined how Montana's tax structure has changed over time by looking at the distribution of taxes by tax type for fiscal years 1980, 1990, and 2000. This section focuses on the change in the tax structure over the period 1980 to 2000.

The following table and charts show how Montana's general state and local government tax structure has changed over the twenty-year period 1980 to 2000.

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>State and Local Taxes</th>
<th>Revenue per $1000 of Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>$358.30</td>
<td>46%</td>
</tr>
<tr>
<td>Selective Sales</td>
<td>95.19</td>
<td>12%</td>
</tr>
<tr>
<td>Income</td>
<td>180.60</td>
<td>23%</td>
</tr>
<tr>
<td>Severance</td>
<td>94.64</td>
<td>12%</td>
</tr>
<tr>
<td>Other</td>
<td>58.07</td>
<td>7%</td>
</tr>
<tr>
<td>Total Taxes</td>
<td>$786.80</td>
<td>100%</td>
</tr>
</tbody>
</table>
The table and charts illustrate the following points regarding changes in Montana's tax structure over time:

- Montana's total tax burden, as measured by revenue per $1,000 of personal income, dropped from $109.10 in 1980 to $102.77 in 2000. (In 1990 revenue per $1,000 of personal income was $115.51; hence, all of this drop occurred in the time period 1990 to 2000).

- Revenue per $1,000 of personal income dropped for property taxes, and dropped significantly for severance taxes from $13.12 in 1980 to just $4.11 in 2000. Revenue per $1,000 of personal income increased over this period for selective sales taxes, income taxes and other taxes.

- As a share of the total burden, Montana relied less on property and severance taxes and more on income, selective sales, and other taxes in 2000 than it did in 1980.

**Tax Structure – Comparison with Neighboring States**

The Tax Reform Study Committee also compared Montana's tax structure to the average tax structure of all 50 states, and to the average tax structure of our immediate neighbors – North Dakota, South Dakota, Wyoming, and Idaho. This comparison, based on fiscal year 2000 data, is shown in the following table and charts.
State and Local Taxes in FY2000
Montana v. All States and Neighboring States

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Montana</th>
<th>%</th>
<th>All States</th>
<th>%</th>
<th>ID + ND + SD + WY</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>908.0</td>
<td>43%</td>
<td>294,177.6</td>
<td>28%</td>
<td>2,540.2</td>
<td>30%</td>
</tr>
<tr>
<td>Selective Sales</td>
<td>345.7</td>
<td>16%</td>
<td>94,177.4</td>
<td>11%</td>
<td>1,022.0</td>
<td>12%</td>
</tr>
<tr>
<td>Income</td>
<td>616.0</td>
<td>29%</td>
<td>277,719.6</td>
<td>28%</td>
<td>1,413.8</td>
<td>17%</td>
</tr>
<tr>
<td>Severance</td>
<td>85.2</td>
<td>4%</td>
<td>4,368.0</td>
<td>1%</td>
<td>396.6</td>
<td>5%</td>
</tr>
<tr>
<td>Other</td>
<td>176.9</td>
<td>8%</td>
<td>61,796.1</td>
<td>7%</td>
<td>712.5</td>
<td>9%</td>
</tr>
<tr>
<td>General Sales</td>
<td>0.0</td>
<td>0%</td>
<td>215,112.4</td>
<td>25%</td>
<td>2,220.5</td>
<td>27%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,131.8</strong></td>
<td>100%</td>
<td><strong>$872,351.1</strong></td>
<td>100%</td>
<td><strong>$8,305.6</strong></td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Structure Comparison ($ millions)</th>
<th>Taxes Per $1,000 of Personal Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Montana</td>
<td>US Average</td>
</tr>
<tr>
<td>$43.77</td>
<td>$29.67</td>
</tr>
<tr>
<td>16.67</td>
<td>11.21</td>
</tr>
<tr>
<td>29.70</td>
<td>29.49</td>
</tr>
<tr>
<td>4.11</td>
<td>0.52</td>
</tr>
<tr>
<td>8.53</td>
<td>7.36</td>
</tr>
<tr>
<td>0.00</td>
<td>25.61</td>
</tr>
<tr>
<td><strong>$102.77</strong></td>
<td><strong>$103.87</strong></td>
</tr>
</tbody>
</table>

Obviously, Montana’s tax structure is different from that of the average of all states and different from the average of our neighboring states in that Montana has no general sales tax. For all states, 25% of total state and local government taxes comes from general sales taxes; for our neighboring states, general sales taxes comprise 27% of total taxes.

Property taxes comprise a much larger share of the tax structure in Montana (43%) than in all states (28%) or in our neighboring states (30%). Montana also relies relatively more on selective sales taxes as a share of total taxes (16%) than the average for all states (11%) and neighboring states (12%).

Montana’s reliance on income taxes (29%), which includes both individual and corporate income taxes, is nearly equal to that of all states (28%), but much higher than that of our neighboring states (17%). This is not surprising given that South Dakota and Wyoming have neither an individual income tax nor a corporate income tax.

Severance taxes represent a very small share of total taxes for all states (1%), but constitute 4% of total taxes in Montana and 5% of taxes in our neighboring states.
make up 16% of total collections in Wyoming and 8% of total collections in North Dakota.

Finally, other taxes make up about the same share of total taxes in Montana (8%) as they do in all states (7%) and in our neighboring states (9%). Other taxes include occupational and business licenses and license taxes; vehicle and driver’s licenses; hunting and fishing licenses; inheritance and gift taxes; and all taxes not meeting the definition for another category.

When looking at tax burden in terms of taxes per $1,000 of personal income, relative tax burdens show the same general relationship as the tax structure share of total taxes, when comparing Montana with all states and our neighboring states. Tax burdens in Montana are significantly higher for property and selective sales taxes; are about the same as all states, but significantly higher than our neighbors, for income taxes; Montana’s burden is about the same as that for our neighbors, but higher than for all states, for severance taxes; and the burden for other taxes is about the same for Montana, all states, and our neighbors. Montana has no tax burden associated with a general sales tax, whereas taxes per $1,000 of personal income are $25.61 for all states and $27.57 for our neighbors.

Overall, Montana, in fiscal 2002, had a slightly lower tax burden of $102.77 per $1,000 of personal income, than either all states ($103.87) or our neighbors ($103.12).

**Montana Finances – Other Observations**

An examination of state and local government finances revealed the following major points (fiscal years):

- Over the period 1980 to 2000, Montana total state and local government revenue grew at an average annual rate of 6.1% whereas total taxes grew at a rate of just 5.1%.

- Over the period 1980 to 2000, Montana total personal income grew at an average annual rate of 5.4%. Over this same period, inflation averaged 3.8% per year; population growth averaged 0.7% per year; and real personal income per capita growth averaged 0.9% per year.

- In 2000, Montana relied much more heavily on current charges and miscellaneous general revenue, and less heavily on federal transfers and taxes, than Montana did in 1980.

- In 2000, Montana relied more heavily on federal transfers and miscellaneous general revenues, and less heavily on taxes, than either all states or our neighboring states.
Section 5

Findings by Tax Type

- Property Tax
- Natural Resource Tax
- Individual Income Tax
- Corporation License Tax
- General Retail Sales Tax
Findings By Tax Type

- Property Tax
- Natural Resource Taxes
- Individual Income Tax
- Corporation License Tax
- General Retail Sales Tax
Property Tax

Based on the Tax Reform Study Committee's discussions, and the preponderance of public testimony in this area, it is clear that property taxes are a major concern for Montanans. Although property taxes, as a percent of total state and local government tax collections, have declined from 46% in 1990 to 43% today, Montana continues to rely much more heavily on this revenue source than do other states. Property taxes comprise just 28% of total state and local government tax collections for all states, and 30% for our neighboring states.

Perhaps more importantly, the share of Montana's total property taxes paid by Class 4 residential and commercial properties has increased from 52% in 1994 to 64% in tax year 2003. This increase in the Class 4 share of the total property tax burden is related largely to property tax reductions for other types of property, notably business equipment and centrally assessed properties; and to increases in local school mill levies, which frequently fall disproportionately on residential and commercial properties.

While the Tax Reform Study Committee discussed several aspects of the property tax, and delved into many issues surrounding this tax, it did not contemplate or recommend proposals to completely reform or overhaul the property tax in Montana. In part, this may be due to the fact that the interim Property Tax Reappraisal Study Committee was examining this tax in great detail and preparing to recommend major changes to the system to address the impacts that reappraisal has on taxpayers. These proposals, including capping the growth in the market value of residential and commercial properties, could have provided the broad reform needed to address the concerns of the Tax Reform Study Committee and Montana taxpayers in general.¹

Nevertheless, several issues and concerns regarding the property tax were discussed by the Tax Reform Study Committee and are presented in following sections. The Committee's final recommendations and proposals for changes to and modifications of the property tax system are presented in the recommendations and proposals section of this report.

Property Tax and School Funding

In testimony provided by members of the interim School Renewal Study Commission, the Tax Reform Study Committee was apprised of the wide disparities and inequities in property taxes levied to fund schools across the state. In fiscal 2004, mills levied to support local school districts' general funds ranged from zero to over 266 mills; and the

¹ See the final report of the Property Tax Reappraisal Study Committee for the conclusions and recommendations reached by that body.
combined mill levied to support all other school funds (transportation, retirement, debt service, etc.) ranged from zero to over 353 mills.

Although the plaintiffs in the school funding lawsuit did not prevail in their argument that this disparity violates equal educational opportunity provisions of the state’s constitution, this disparity nevertheless remains a serious concern of the members of the School Renewal Study Commission. They argued that the wide disparities from district to district in property tax bases, and in the mill levies required to fund local school districts, is a major impediment to consolidation of school districts. Taxpayers in more wealthy school districts are often opposed to consolidating with adjacent low wealth districts because of the attending increase in mill levies that would be required to support the low wealth district after consolidation.

However, consolidation of school districts is one of the more viable means of increasing efficiencies in the school funding system. Leveling the local mills needed to fund school districts by means of additional state funding — whether it be through an increase in the statewide mill levied for schools or with general sales tax revenues — would act to alleviate the disincentive for consolidation and could lead to natural consolidations of school districts based on factors other than tax consequences.

Class 8 Business Equipment — Current Law “Trigger”

Perhaps no other issue received as much attention during the Tax Reform Study Committee’s discussions of property taxes as the current law Class 8 property tax “trigger.”

Senate Bill 200 (1999) reduced the taxable valuation rate applied to business equipment from 6% to 3%, and further provided for a “trigger” mechanism that would phase out the tax on business equipment entirely once annual inflation-adjusted growth in Montana wage and salary income exceeds 2.85%. Since its passage, there has not been a year in which this trigger has been met; consequently, the taxable valuation rate on business equipment remains at 3% today. As of this writing, the earliest that the trigger could begin a phase down of the business equipment tax rate is tax year 2007.

Regarding the trigger, opinions expressed by both the general public and members of the Tax Reform Study Committee ranged from keeping the trigger in place to repealing the trigger altogether. Some argued that keeping the trigger in place, or providing for further immediate reductions in business equipment taxes, was necessary to make Montana competitive with neighboring states that have no business equipment taxes, and to further promote and enhance economic development and job creation. Others argued that at 3% the tax on business equipment was generally competitive, given that Montana does not tax the sale of business equipment; that previous reductions had done little to spur additional investment; and that the state could not afford the revenue losses associated with eliminating the tax on business equipment.
There are many implications associated with the elimination of the tax on business equipment. The general tax impacts, the specific impact on tax increment financing districts (TIFs), and some legal ramifications were discussed during the Committee's hearings, and are detailed in the following sections.

**Tax Impacts**

Clearly, in the absence of any immediate economic response, eliminating the tax on business equipment would result in significant revenue reductions to state and local governments. The following table shows the estimated tax impacts over time under the assumption that the Class 8 business equipment tax trigger is effective first for tax year 2007. The tax rate would drop from 3% to 2% in tax year 2007; from 2% to 1% in tax year 2008; and business equipment would not be taxed in tax year 2009 and thereafter.

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Estimated Reduction in Taxable Value</th>
<th>Estimated Reduction in Property Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Trigger Not Hit</td>
<td>Trigger Hit</td>
</tr>
<tr>
<td>2006</td>
<td>123,072,945</td>
<td>123,072,945</td>
</tr>
<tr>
<td>2008</td>
<td>130,335,061</td>
<td>70,896,538</td>
</tr>
<tr>
<td>2010</td>
<td>138,023,771</td>
<td></td>
</tr>
</tbody>
</table>

There is a small reduction in tax in fiscal 2007 of about $8 million attributable to personal property that is not lien to real property; the tax on this type of property is paid in the spring of each year. The tax impacts grow each fiscal year as the tax rate decreases and is phased down to zero, with the first full-year impact reached in fiscal year 2010. At that time the total reduction in property taxes is estimated to be $67.6 million. Of this amount, $12.1 million represents a reduction in revenue to the state general fund. The revenue reduction to local governments and schools is $48.4 million.

Local governments were reimbursed for the reductions in revenue associated with the rate decrease from 6% to 3% in SB200. However, the Montana Legislature has not made a determination of whether local governments would, or should, be reimbursed for revenue losses if the trigger is hit. If the decision is made to reimburse local governments, including school districts and tax increment financing districts, then the impact on the state general fund would be the total amount of the revenue reduction (except for the University System amount) in each year.

If the decision is made not to reimburse local governments and school districts, then it is likely that these taxing jurisdictions would raise their mill levies to compensate for the reduction in taxable valuation associated with the phase out of the business equipment tax, and the reduction in revenue would be shifted to and recouped from other classes of property. The exact impacts on each taxing jurisdiction, and the amount of the revenue reduction that would “float” to other property classes will depend on the mix of
property in each of the local government taxing jurisdictions. Statewide, it is estimated that about 60% of the revenue reduction to local governments and schools would be shifted to Class 4 residential and commercial properties; 21% would be shifted to utility property in Classes 9, 12, and 13; and 19% would be shifted to agricultural land, forest land, and other properties.

Impacts on Tax Increment Financing Districts (TIFs)

As the above table shows, reducing the tax rate applied to Class 8 business equipment would reduce revenue flowing to tax increment financing districts across the state by an estimated $6.4 million when the tax on business equipment is completely eliminated. Tax increment financing districts usually issue bonds at the beginning of their life to provide funding for immediate improvements within urban renewal districts. These bonds are serviced with the revenues that flow to TIFs from state and local mills levied on the increment values within the TIFs. These increment values include the value of business equipment put in place after the formation of the TIF. In the case of the state's largest TIF in Butte-Silver Bow County, nearly all of the increment value is attributable to business equipment; but all TIF increment values contain some business equipment.

If the trigger is hit, and taxes on business equipment were to be eliminated, then increment districts would lose a very significant source of revenue for servicing their bonds. To maintain the financial viability of TIFs, the Montana Legislature would either have to provide reimbursements to TIFs for the amount of revenue reduction associated with eliminating business equipment taxes, or local jurisdictions may have to provide for a special levy to replace the revenue needed to service these bonds.

Legal Ramifications

The full extent of the impact of a complete repeal of property taxes on Class 8 business equipment is unclear, and would likely be decided by the courts. Some contend that if personal property in Class 8 is exempt from taxation that taxpayers with personal property in other tax classes – particularly centrally assessed properties, railroads and airlines – would have a legal claim for exemption of similar personal property in those classes as well. If this is true, then the tax impacts of eliminating property taxes on Class 8 business equipment would be far greater than those shown in the above table.

Legal opinions on this matter are inconsistent. The Legislative Services Division has issued an opinion that personal property in other property tax classes would not attain exempt status by virtue of repealing property taxes on Class 8 business equipment. But court cases in other states suggest that the matter is not certain. Ultimately, the issue may have to be decided by Montana courts.
Class 8 Business Equipment – Other Proposals

The Tax Reform Study Committee also examined and discussed two other proposals pertaining to Class 8 business equipment.

Increase Current Law $5,000 Exemption Level

In addition to reducing the tax rate on business equipment from 6% to 3%, SB200 also provided that taxpayers whose businesses have less than $5,000 in market value of business equipment are exempt from property taxes on that equipment. Without a general reduction in the taxable valuation rate applied to business equipment, one alternative that would provide small businesses with property tax relief would be to increase this current law $5,000 threshold.

The following table provides the revenue impact of increasing this threshold to alternative levels based on tax year 2003 valuations and mill levies (exclusive of mills levied for fire and other miscellaneous taxing jurisdictions).

<table>
<thead>
<tr>
<th>Proposed Exemption Level Based on Market Value</th>
<th>Estimated Impacts of Increasing the Current Law $5,000 Exemption Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Affected Individual Taxpayers</td>
<td>Additional Reduction in Taxable Value due to the Exemption</td>
</tr>
<tr>
<td>$10,000</td>
<td>6,710</td>
</tr>
<tr>
<td>$15,000</td>
<td>10,721</td>
</tr>
<tr>
<td>$20,000</td>
<td>13,372</td>
</tr>
<tr>
<td>$25,000</td>
<td>15,367</td>
</tr>
<tr>
<td>$50,000</td>
<td>20,909</td>
</tr>
<tr>
<td>$100,000</td>
<td>25,333</td>
</tr>
<tr>
<td>All Exempt</td>
<td>29,722</td>
</tr>
</tbody>
</table>

At each proposed exemption level, taxpayers whose total market value of business equipment is less than the exemption amount would be exempt from property tax on all their business equipment; taxpayers whose total market value of business equipment exceeded the exemption level would be taxed on all of their business equipment.

As the spreadsheet shows, increasing the exemption level to levels up to the $25,000 range has a relatively small revenue impact (revenue reduction of $2.8 million at the $25,000 level). Even increasing the level to $100,000 has an impact of just $10.3 million. Exempting all business equipment would reduce property taxes by about $58 million (not counting mills levied for fire and miscellaneous districts, which increases the impact to about $60 million).
What this indicates is that the vast majority of Class 8 business equipment taxes is paid by a fairly small percentage of all firms with business equipment; but those firms, such as the ASiMi plant in Butte-Silver Bow County, have very large amounts of business equipment.

One of the proposals from the Tax Reform Study Committee is to increase this exemption threshold; however, no specific threshold amount was specified or endorsed by the Committee as a whole.

**Combine Class 8 Business Equipment with Class 4 Properties**

The Tax Reform Study Committee also discussed the option of combining Class 8 business equipment with Class 4 residential and commercial properties, in lieu of allowing the trigger to take effect. Under this proposal, the current 3% taxable valuation rate on business equipment would increase slightly to the Class 4 rate. This rate is scheduled to decline gradually from 3.22% in tax year 2005 to 3.01% in tax year 2008. To prevent any increase in the overall amount of taxes paid by business equipment as a whole, this proposal could be combined with an increase in the exemption level, as discussed in the previous section, to make the proposal revenue-neutral on business equipment overall.

Combining Class 8 business equipment with Class 4 residential and commercial properties would afford business equipment with a certain amount of insurance against increases in taxation in the future. Historically, the Montana Legislature has been reluctant to increase the Class 4 tax rate. In fact, the historic approach to Class 4 reappraisal has been to reduce the tax rate applied to these properties to maintain revenue-neutrality following each reappraisal cycle. Including business equipment in Class 4 would allow the tax rate on this property to decrease following reappraisal cycles as well, provided the Montana Legislature opted to continue this general approach in future reappraisal cycles.

While this approach was discussed on several occasions, the Tax Reform Study Committee did not formally include this approach in the final proposals submitted to the Montana Legislature for consideration.

**Tax Increment Financing Districts**

The Tax Reform Study Committee was provided with a general overview of tax increment financing districts (TIFs), and discussed them on several occasions. Several issues arose regarding these unique economic development tools, but no formal recommendations or proposals regarding TIFs emerged from the committee.

In short, TIFs are created by resolution of city and county governing bodies. Once the TIF district has been designated, any additions to property within the TIF district boundaries become part of the TIF *increment*, and the revenue generated by applying
state and local mill levies to property within the increment accrues to the TIF district, rather than to the taxing jurisdictions. These revenues are then used either to service bonds issued by the TIF district or to provide direct funding for economic development projects within the district.

TIFs provide municipalities with a means of generating revenue for urban renewal, infrastructure development, and other economic development projects. Once the TIF expires, the added development reverts to the tax base of those taxing jurisdictions in which the TIF resides. During the lifetime of the TIF, mill levies for those taxing jurisdictions in which the TIF resides are slightly higher than they otherwise would be as revenue from property within the TIF is not available to those jurisdictions but instead flows to the TIF district. Prior to the end of their lives, TIF districts may release a portion or all of their increment to other taxing jurisdictions, resulting in either a decrease in the mills levied for those jurisdictions, or additional revenues for those jurisdictions.

In tax year 2004, a total of $32.2 million in taxable value was included in TIF increments statewide. This resulted in a total of $19.6 million in property tax revenue that accrued to TIF districts that otherwise would have accrued to taxing jurisdictions in the areas where the TIFs are located. Of the $19.6 million, $3.1 million would have accrued to the state general fund; $8.8 million would have accrued to local schools; and $7.7 million would have accrued to local governments.

The Montana Legislature, when deliberating and debating tax policy, may wish to take into consideration the following issues that arose during the Tax Reform Study Committee's discussion of tax increment financing districts:

- Allowing the Class 8 business equipment trigger to take effect will significantly reduce revenues flowing to TIFs. How will this revenue be replaced? (This issue was discussed in greater detail in the above section on the Class 8 trigger.)
- Comprehensive tax reform proposals that include eliminating the 95 mills currently levied statewide for the state general fund would also reduce revenues to TIFs significantly, as these mills represent close to one-fifth of all revenue currently accruing to TIFs. How would this revenue be replaced in proposals of this nature?
- Why are TIFs allowed to retain revenue from the 95 mills levied statewide for state general fund purposes? Why are taxpayers in communities without TIFs subsidizing economic development in communities with TIFs? Should the 95 mills for the state general fund be exempt from future TIFs in the same manner that the statewide 6 mills levied for the University System currently are exempt? If the purpose of TIFs is for local economic development, why aren't just the local government and school district mill levies used for this purpose, as is the case in the local property tax abatement program provided for in Title 15, Chapter 24, Part 14?
- Finally, given the impact on the mill levies of local governments and school districts, should the creation of a TIF be subject to a vote of taxpayers affected by the TIF?
Other Issues

Net Proceeds

As discussed in the section on natural resource taxation, the Tax Reform Study Committee heard a great deal of testimony pertaining to the taxation of bentonite mines in Montana. Much of that discussion focused on how the net proceeds approach to establishing the tax base for certain mining operations is fraught with uncertainty and ambiguity, in both the statutes and the calculations used to define and determine net proceeds.

This ambiguity frequently has led to disputes and litigation over the appropriate costs to be deducted in determining net proceeds, and the manner in which net proceeds should be calculated in general. On several occasions, testimony — including that from members of the Tax Reform Study Committee, the director of the Department of Revenue, and the general public — indicated that moving away from the net proceeds approach to either a gross proceeds or other approach would act to remove uncertainty in determining the tax base for mining operations, and increase certainty in taxpayer liabilities and state and local government revenues.

Testimony indicated how Montana historically has been moving away from the net proceeds approach to other approaches, as has occurred in the taxation of coal (gross proceeds), oil and natural gas (flat rates), and several miscellaneous minerals where the tax base is established directly in statute as an inflation-adjusted value per ton of mineral extracted.

While no formal recommendation or proposal emerged from the Tax Reform Study Committee addressing net proceeds taxation in general, many members of the Committee indicated their preference that the Montana Legislature consider eliminating all forms of taxation based on net proceeds and move to other less ambiguous means of establishing the tax base for certain mining operations.

Pipelines

During their deliberations, the Tax Reform Study Committee briefly touched on a concern regarding the taxation of oil flow lines and natural gas gathering lines, referred to in general here as “pipelines.”

Under the current property tax classification system it is possible for similar pipeline property to be taxed at substantially different tax rates depending on the circumstances surrounding the operations of the pipeline. Pipelines that are owned and operated within a single county are classified as Class 8 business equipment, which is subject to a taxable valuation rate of 3%. Certain other pipelines that are connected to a transmission line that crosses county lines are included in Class 9 centrally-assessed properties, and are taxed at a taxable valuation rate of 12%. Of concern is that this disparity may result in profit differentials between pipeline companies that arise purely
as a consequence of the tax code, thereby violating the underlying guiding principal that
tax structures should be economically neutral.

Spurring consideration of this issue is the fact that as of this writing at least three
lawsuits have been filed contesting the tax treatment of various pipelines in different
locations across the state. These lawsuits involve definitional issues that ultimately
require designating various types of pipeline property as being either centrally- or
locally-assessed properties, and then classify and taxing them accordingly.
To address the confusion in this area, and to provide for consistent treatment of
similarly situated properties, the Committee has included the following approach in its
suggested proposals for consideration by the Legislature.

This approach would provide that all “flow lines” and “gathering lines” be considered
Class 8 business equipment for property taxation purposes, while “transmission” lines
would continue to be taxed as centrally-assessed property in Class 9.

The Committee also discussed, but did not recommend, a second approach which
would place all “pipelines” in Class 13 and tax them at a uniform rate of 6%. While
there are advantages and disadvantages to both approaches, the Tax Reform Study
Committee provides these alternatives as starting points for further discussion and
eventual resolution of these issues by the Montana Legislature.

Classification System

Montana has one of the most unique and complicated property tax classification
systems in the country. Currently, property is classified into one of 12 different property
classes with taxable valuation rates ranging from 0.35% (productivity value of
forestland) to 100% (net proceeds of mines other than coal and metal mines). In tax
year 2004 business equipment was taxed at 3%; agricultural land and residential and
commercial properties were taxed at a rate of 3.3%; electric generation and centrally-
assessed telecommunications properties were taxed at 6%; and other centrally
assessed properties (pipelines and electric transmission and distribution systems) were
taxed at 12%.

These wide disparities in taxable valuation rates, coupled with annual appraisals for
some properties (business equipment, centrally-assessed properties) while other
properties (residential and commercial properties) are appraised on a six-year cycle,
lead some members of the Tax Reform Study Committee to view the overall system as
inequitable. To some, the current classification system is a remnant of an outmoded
industrial age and should be updated to a system that reflects a more contemporary
economy characterized more by high-tech firms operating in deregulated rather than
regulated markets. They cite the past efforts of groups like the Montana Association of
Counties to repeal the classification system in its entirety and tax all property at a

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2 Encana Energy Resources, Inc. v. Montana DOR; Omimex Canada, Ltd. v. Montana DOR; and
Montana-Dakota Utilities, Williston Basin Interstate Pipeline Co., and Fidelity Exploration and Production
Co. v. Montana DOR.
uniform percent of value as a preferable approach to property taxation in today’s economic environment.

These same Tax Reform Study Committee members also recognize that such a large scale reform of the property tax system standing alone would likely result in many winners and losers, and that reform of this type is best accomplished within the context of comprehensive reform of the entire tax structure. The recommendations and proposals section of this report provides one proposal that would gradually move the system in this direction.
Natural Resource Taxes

The Tax Reform Study Committee was provided with a substantial amount of information and public testimony pertaining to natural resource taxes, including taxes levied on electric energy generation. The Committee was provided with a comparison of tax rates and taxing structures across selected states for coal, oil and natural gas, and metal and miscellaneous mines. This information also addressed variations in the taxation of royalties across mineral types.

During the course of their deliberations, the Tax Reform Study Committee's discussions regarding natural resource and electrical energy generation taxes eventually focused on three main issues. The first two issues are closely related and deal with tax incentives to promote development of new coal-fired generation facilities in Montana. The third issue addresses current taxation policies regarding mining of bentonite. These issues are discussed in detail in the following sections.

Coal Severance Tax

The Tax Reform Study Committee was apprised that currently there are at least four new coal-fired facilities that are either under construction, have been permitted, or are being discussed in Montana. MCA, 15-35-103 provides for the state severance tax applied to coal production. Coal industry representatives identified three changes to this section of law that they believed would facilitate these projects, and enhance the opportunity for economic development and job creation in the coal sector in Montana.

Under current law, the tax rate applied to coal that meets certain conditions is one-third the normal rate (SB134, 2001 Legislative Session). To qualify for the reduced rate, the coal must first be used to produce electricity in an in-state, coal-fired power plant that was constructed after December 31, 2001 and before January 1, 2008. Under the second condition, the operator of the power plant must offer, for use within the state, the first half of power produced to Montana consumers at a cost set by the Public Service Commission that reflects the cost of production plus a reasonable rate of return.

Coal industry representatives noted that there is great interest in new coal-fired electric energy production in Montana; but because of the amount of time it takes to actually work through the permitting process, and the time it takes to actually construct a coal-fired plant, the sunset date of January 1, 2008 should be eliminated to accommodate the new plants under consideration. An acceptable option would be to provide the reduced coal severance tax rate for a period of 20 years following initial production of electricity from a new plant, which would allow the new plant to recapture its initial costs of construction.
Of concern to some Tax Reform Study Committee members and industry representatives was how this incentive would affect the overall competitive environment of the industry, as existing power plants would not be eligible for the incentive. It was suggested that most of the existing plants were fairly old and have had sufficient time to recoup the costs of construction and, consequently, were already operating under lower costs than those for new plants.

Industry representatives also argued that the second requirement – that the operator of the power plant must offer, for use within the state, the first half of power produced to Montana consumers at a cost set by the Public Service Commission – should be eliminated. First, energy generation from wholesale generators is no longer regulated by the PSC; and, second, the provision is likely to be in violation of the Commerce Clause of the US Constitution in any event.

The third change to current statutes would provide that the costs associated with “drying” or “washing” coal should be excluded from the contract sales price used to establish the tax base for the severance tax. An existing section of law (MCA, 15-35-103(5), scheduled to terminate December 31, 2005) had provided for an exemption from severance tax for the first 2 million tons of coal produced as feedstock for a coal enhancement facility. That section had been written for the coal dryer at Colstrip, which has since been dismantled.

A new coal-fired generation facility that has passed the permitting process and is contemplated for construction near Roundup will use coal from the nearby Bull Mountain Mine. This coal will be “washed” prior to being used in the facility. Industry representatives suggested that the costs associated with washing this coal should not be included in the contract sales price used to determine the severance tax on this coal, as production costs at the Bull Mountain Mine are already very high.

Finally, during their discussions on the coal severance tax, members of the Tax Reform Study Committee noted that MCA, 15-35-103 contains a provision in subsection 3 requiring that “...the formula that yields the greater amount of tax in a particular case must be used at each point on the schedule.” It was noted that this language pertains to a tax rate schedule that existed in law years ago that no longer exists; that law provided that the tax rate was either a percentage of value or a flat tax per ton, whichever produced the larger tax liability. Given that the tax rate schedule no longer provides any reference to a flat tax per ton, the committee believes this language should be stricken from the statutes.

**Electrical Generation and Delivery Facilities**

Senate Bill 508 (2001 Legislative Session) provided new tax incentives for the construction of electrical generation facilities and related delivery facilities (transmission lines). Among other things, that bill provided that facilities constructed after May 5, 2001 and before January 1, 2006 may be exempt from property taxation for a 10-year
period (5-year period for oil or gas turbines) beginning on the date that construction commences. To be exempt from property taxation, the owner is required to offer contracts to sell half of the facility’s output at a cost-based rate, including a rate of return not to exceed 12%, to customers for a 20-year period from the date of the facility’s completion.

As with the severance tax incentive, industry representatives argued that the sunset date of January 1, 2006 did not allow ample time for the planning, permitting and construction process for new facilities, and requested that the sunset date be eliminated or extended. There was also some concern on the part of Tax Reform Study Committee members that that requirement to sell half of all energy generated at the contract terms specified may also be in violation of the Commerce Clause.

At the July 12, 2004 (9th) meeting of the Tax Reform Study Committee, it was moved to amend 15-24-3001(1) to extend the sunset date by which the property tax exemption could be provided from January 1, 2006 to January 1, 2011. The motion passed on a vote of 10-1.

**Constitutional Issues – Legal Opinion**

Given the uncertainties surrounding the constitutionality of the contract provisions discussed in both of the above sections, the Committee requested that Mr. Greg Petesch, Code Commissioner, Legislative Services Division provide a written legal opinion addressing these issues. Mr. Petesch provided a written opinion on these and other matters to the Committee, and discussed the opinion with the Committee at their August 9, 2004 (10th) meeting.

In short, Mr. Petesch noted that there is a fundamental distinction between the contractual obligations at 15-35-103, MCA when compared to those provided for at 15-24-3001, MCA, in that the contractual obligations at 15-35-103 require that half the power produced be offered at what may be considered a preferential rate to Montana customers, whereas the contractual obligations at 15-24-3001 simply require that half the power be offered “to customers,” without any distinction that they be Montana customers. Mr. Petesch concluded that the contractual provisions at 15-35-103, because of the preferential treatment of Montana customers, would likely not withstand a challenge based on the Commerce Clause of the US Constitution, but that the contractual obligations at 15-24-3001 likely would withstand such a challenge.

In other matters, Mr. Petesch concluded that tax preferences provided generally to new firms, but not provided to existing firms, would likely withstand Commerce Clause challenges as long as the Montana Legislature offered a rational basis for why the tax preference is being provided.
Bentonite – Mines Net Proceeds Tax

In Montana, bentonite is mined in Carbon and Carter Counties; both counties are border counties with Wyoming. The Tax Reform Study Committee heard public testimony provided by American Colloid Company and Bentonite Performance Minerals that suggested that the difference in how net proceeds are taxed in Montana relative to Wyoming could lead to significant cut backs, or even complete closures, of mining operations in Montana, as those operations are moved to Wyoming where the tax rate is substantially lower.

American Colloid Co. (Carter County) contends that taxes per ton are 3 to 4 times higher in Montana than in Wyoming. Bentonite Performance Minerals contends that Montana taxes per wet ton of bentonite mined over the past five years have ranged from 3 to 7 times those of Wyoming. They further indicated that the high property tax rate in Carter County has already prompted them to reduce bentonite production in Montana and shift production to Wyoming.

Bentonite producers and other participants suggested several options that could be used to reform the taxation of bentonite and reduce the effective tax rate on Montana bentonite production. The options discussed included:

- gradually reduce the taxable valuation rate on bentonite net proceeds from 100% to 50% over a five-year period;
- implement a flat tax per wet ton mined, or a graduated flat tax per ton;
- change the tax from a net proceeds to a gross proceeds basis with an appropriate taxable valuation rate applied to gross proceeds;
- revise the net proceeds calculation to include costs of production not currently allowed when calculating net proceeds; and
- remove bentonite from state taxation (101 mills) by repealing current provisions of law and establishing a new local government severance tax on bentonite.

The final recommendation from the Tax Reform Study Committee addressing the taxation of bentonite is discussed in detail in the section of the report that discusses the Committee’s recommendations and proposals for tax reform.

The Tax Reform Study Committee recognizes that one of the issues in the net proceeds arena is that determining net proceeds is frequently a contentious issue, resulting in appeals and litigation to establish which business expenses are legally deductible in the net proceeds calculation. Consequently, there has been a gradual movement away from net proceeds taxation in Montana to methods that are less contentious.

For example, metal mines and oil and gas production, which previously had been taxed on a net proceeds basis, are now taxed on either a flat rate or gross proceeds basis. Furthermore, several minerals, including talc, vermiculite, limestone and industrial garnets, taxed under the net proceeds statute are now taxed simply on the basis of a fixed value per ton, rather than on a complicated calculation of net proceeds. These
alternative approaches not only eliminate most of the controversy in establishing taxable value, but also provide consistency over time, allowing both local governments and mining companies to more effectively conduct long-term planning. At least one Tax Reform Study Committee member suggested that the state should move all net proceeds taxes to a gross proceeds basis to eliminate confusion in identifying and calculating net proceeds.

Another concern is that any change in taxation away from the net proceeds basis to a basis that provides for more certainty and stability, in a revenue-neutral fashion, would likely result in a shift in the tax burden. Taxes are likely to shift not only between the various companies producing bentonite, but between Carbon and Carter Counties as well.

Furthermore, reducing taxes paid by bentonite producers is very likely to result in an increase in taxes paid by other types of property. Simply reducing the taxable valuation rate from 100% to 50% would require an increase in mills levied by county governments and school districts in order for those taxing jurisdictions to continue current service levels. This increase in the mill levy would also be applied to the property and net proceeds of bentonite producers, acting to offset a portion of the tax reduction that would occur in the absence of any mill levy response.

This situation is more acute in Carter County, where in tax year 2002 net proceeds comprised 59% of the total property tax base, than in Carbon County, where net proceeds comprised just under 1% of the total property tax base.

Providing for an overall reduction in taxes paid by bentonite producers through the flat tax per ton approach would shift all of the property tax increase required to maintain current level services to property other than bentonite producers, as these companies would no longer be paying taxes based on property values subject to a mill levy.

Clearly, all of the burden shifts mentioned above would be unfavorably viewed by those taxed or taxing entities that would experience an increase in tax burden. However, a smaller increase in tax burden would likely be preferable to the increase that would occur if bentonite production were to cease entirely.

There were many discussions between bentonite producers, county government officials, and other parties on how best to resolve the issues surrounding bentonite taxation. However, as of this writing there has been no consensus as to how this might best be accomplished.

**Bentonite – Royalties Net Proceeds / Individual Income Tax**

In public testimony provided on behalf of Sage Creek Minerals, the Tax Reform Study Committee was apprised of a Wyoming-Montana border issue pertaining to the taxation of royalties paid to holders of bentonite claims. In Montana, royalties for property tax
purposes are being taxed at a rate of 100% of the royalty amount paid, times the consolidated mill levy in the jurisdictions in which the mine is located. In Carbon County, this resulted in a net property tax equal to 39% of the royalty amount.

The balance of the royalty payment remaining after property taxes is subsequently taxed in Montana for individual income tax purposes. At an 11% marginal income tax rate, the combined effective tax rate on bentonite royalties can be as high as 45.7%. In contrast, just across the border in Wyoming there is no property tax on royalty payments, and there is no income tax. It was suggested that Montana, in order to maintain economic viability for in-state holders of bentonite claims, reduce the tax on royalties from bentonite production to 15% of the royalty amount paid. The resulting amount of tax would then be distributed on the basis of the relative mill levies of the taxing jurisdictions in which the specific mine for which the royalties are being paid is located, excluding the 101 mills levied statewide for state government purposes.

Other Testimony

In other natural resource matters, the Montana Petroleum Association provided testimony indicating that they do not feel that the current effective tax rate on oil and gas production in Montana is out of line with tax rates in other states. Montana is about in the middle of the pack with the other states that we compete with directly, and the association indicated they were comfortable with the current level of taxation in Montana.
Individual Income Tax

Although it was discussed on several occasions, reforming Montana's individual income tax did not appear to be a central focus of the Tax Reform Study Committee as a whole. In part, this may be due to the fact that the 2003 Montana Legislature had just passed the first major reform of this tax since 1980 (SB407), and underlying public sentiment indicated that the state should allow those reform measures to take hold before contemplating any further reform actions for this tax.

On those occasions where the Tax Reform Study Committee did discuss the individual income tax, the conversations covered a very broad spectrum running from repealing the 2003 tax reform provisions, to providing additional reform to greatly simplify the tax structure and reduce even further overall liabilities associated with this tax in order to promote and foster economic development in the state. The general opinion of the Committee and the public is that further reform of the individual income tax would more easily be accommodated within the context of comprehensive tax reform, whereby implementation of a general retail sales tax would provide revenues sufficient to allow substantial reductions in individual income and/or property taxes.

Following sections discuss the major concepts and proposals addressed by the Tax Reform Study Committee.

**Senate Bill 407, 2003 Legislative Session**

Senate Bill 407, the Montana Economic Development Tax Act, passed during the 2003 Legislative Session, provided for the most comprehensive revision of Montana's individual income tax since 1980. The Tax Reform Study Committee was provided with several presentations that covered the individual income tax impacts stemming from SB407, including the overall impacts by filertype (single, head of household, married couples, etc.), and by detailed income bracket and decile groupings.

The Tax Reform Study Committee also heard a presentation that provided a comparison of the relative rankings of the effective top marginal tax rates for both ordinary income and capital gains income of several western states prior to and after SB407. SB407 acted to significantly reduce Montana's top ranking among states with respect to the marginal tax rate applied to both ordinary and capital gains income.

Information presented to the Montana Legislature during the 2003 Legislative Session and afterward aggregated the impacts of SB407 for all households with incomes of $500,000 or greater. One of the concerns expressed by the Tax Reform Study Committee was whether or not SB407 resulted in a net reduction in liabilities for households within disaggregated income brackets above this level.
The following table, showing the disaggregated impacts of SB407 for households with income above $500,000, was provided to the Tax Reform Study Committee. As the table shows, average effective tax rates are reduced for all disaggregated income brackets above $500,000 under SB407. The average reduction in tax liability ranges from $4,669 for households with income between $500,000 and $600,000 (11.8% reduction on average); to $106,623 for households with incomes greater than $4,000,000 (14.4% reduction on average).

<table>
<thead>
<tr>
<th>SB407 - Breakdown of Top Income Bracket ($500,000 and Over)</th>
<th>All Households - Tax Year 2006 Impacts</th>
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<tbody>
<tr>
<td>IMPACTS BY INCOME BRACKET</td>
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<tr>
<td>Income Bracket</td>
<td>Number of Households</td>
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<tr>
<td>-----------------------------------------------------------</td>
<td>----------------------</td>
</tr>
<tr>
<td>$500,000+</td>
<td>785</td>
</tr>
<tr>
<td>$500,000 - $599,999</td>
<td>228</td>
</tr>
<tr>
<td>$600,000 - $699,999</td>
<td>137</td>
</tr>
<tr>
<td>$700,000 - $799,999</td>
<td>94</td>
</tr>
<tr>
<td>$800,000 - $899,999</td>
<td>50</td>
</tr>
<tr>
<td>$900,000 - $999,999</td>
<td>50</td>
</tr>
<tr>
<td>$1,000,000 - $1,499,999</td>
<td>95</td>
</tr>
<tr>
<td>$1,500,000 - $1,999,999</td>
<td>45</td>
</tr>
<tr>
<td>$2,000,000 - $2,999,999</td>
<td>36</td>
</tr>
<tr>
<td>$3,000,000 - $3,999,999</td>
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</tr>
<tr>
<td>TOTALS</td>
<td>785</td>
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</table>

Notwithstanding the fact that average tax rates are reduced in each of the income brackets, tax liabilities increase for 123 (16%) of the 785 households with incomes above $500,000. The Tax Reform Study Committee was also provided with information that indicates that for many of these “losing” households, the increase is likely of a one-time nature. Studies of the impacts of proposals very similar to SB407 prior to the 2003 session showed that taxpayers in the higher income brackets with a tax increase in any single year very rarely would have a tax increase in each year over a three-year period under SB407.

The SB407 revisions to the income tax, which provided for an 8-9% overall reduction in revenues from this source when fully phased in, were just one part of this major funding bill of the session, however. The bill also increased the cigarette tax from 18¢ to 70¢ per pack; increased taxes on other tobacco products; and provided for new selective sales taxes on accommodations (3%) and vehicle rentals (4%). Given the previous accommodations tax of 4%, the combined tax on accommodations including the new sales tax is now 7%.

While the tax increases on cigarettes, other tobacco products, and the two selective sales taxes were implemented almost immediately, the revisions to the individual income tax were delayed until January 1, 2005. As a result, the bill provided net new revenue of about $72 million to fund ongoing state government programs during the 2005 biennium.

As shown in the following table, SB407 net revenue impacts in the 2007 biennium turn negative beginning in fiscal 2007, with revenue reductions from the income tax
exceeding revenue increases from the selective sales tax increases by about $14 million. The net revenue reduction in fiscal 2008 was projected to be about $17 million.

It was noted by some committee members that the added revenue from the selective sales tax increases has been committed to ongoing state government programs and is now in the base of those programs. Consequently, the added revenue from these sources in the 2007 biennium should be viewed as necessary to maintain these programs at their current levels. From this point of view, because that revenue is already dedicated, the issue that the 2007 Montana Legislature will have to address is whether the state can afford the $92 million reduction in income taxes that will arise during the 2007 biennium as a result of the revisions to the individual income tax in SB407; or will this reduction in revenue contribute to what some view as an on-going structural deficit in Montana.

### SB407 - Long-Term Impacts Based on Fiscal Note Provided on April 24, 2003

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<tr>
<td><strong>Revenue Enhancement</strong></td>
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<tr>
<td>Accommodations Tax - 3% increase</td>
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<td>Rental Car Tax - 4%</td>
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<td>Other Tobacco Products Tax (12.5% to 25%, Most Snuff @ 35 cents per oz)</td>
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<td>1,700,388</td>
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<td>Cigarette Tax at 52 cents increase ($0.18 + $0.52 = $0.70)</td>
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<td>26,351,268</td>
<td>25,404,578</td>
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<td><strong>TOTAL INCREASED TAX REVENUE</strong></td>
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<td>$39,284,333</td>
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</tr>
<tr>
<td>Income Tax Reform</td>
<td>$ (38,946,000)</td>
<td>$ (52,975,000)</td>
<td>$ (55,824,000)</td>
<td>$(15,752,000)</td>
</tr>
<tr>
<td>DOR Tax Administration Cost</td>
<td>$ (8,647)</td>
<td>$ (9,070)</td>
<td>$ (9,533)</td>
<td>$(18,543)</td>
</tr>
<tr>
<td>Agency Accommodations Tax Payments</td>
<td>$ (90,400)</td>
<td>$ (93,329)</td>
<td>$ (98,265)</td>
<td>$(178,322)</td>
</tr>
<tr>
<td><strong>TOTAL REVENUE REDUCTIONS</strong></td>
<td>$(39,045,137)</td>
<td>$(53,077,408)</td>
<td>$(55,729,788)</td>
<td>$(15,948,935)</td>
</tr>
<tr>
<td><strong>NET REVENUE IMPACT</strong></td>
<td>$822,793</td>
<td>$(13,813,075)</td>
<td>$(17,020,573)</td>
<td>$71,531,425</td>
</tr>
</tbody>
</table>

Proponents of repealing the income tax provisions of SB407 also argued that SB407 reduced the progressivity of the tax, and that progressivity should be reinstated, as progressive income taxes incorporate the concepts of ability to pay. Also, even though the provisions of SB407 addressed the "perception problem" that Montana's top marginal tax rate was too high, the real issue is revenue and fairness, and SB407 acted to reduce both of these.

From another point of view, it was the opinion of other Tax Reform Study Committee members and the general public that the state should continue to reform, simplify and reduce individual income taxes in order to attract job-creating entrepreneurs, and further enhance economic development in the state. According to anecdotal evidence discussed by some Committee members, Montana's income tax remains punitive at the high end of the income scale, resulting in people either leaving the state, particularly when businesses and farms sell and capital gains taxes are due on the proceeds, or in people not coming to the state to begin with. Further reducing and simplifying income
taxes would act to benefit the long-term standing of Montana with respect to the business climate and job development.

From this perspective recurring themes espoused by many on the Tax Reform Study Committee included the following:

- The individual income tax is too complicated. There are too many provisions that require complicated calculations – such as the phase-outs associated with the $3,600 retirement income exclusion and itemized deductions – for ordinary citizens to easily fill out their tax forms. Also, the ability of two-earner married couples to file separate tax returns greatly complicates the filing, administration, and auditing process. The state should strive to get the vast majority of income tax filers on a greatly simplified short form.

- The individual income tax is too progressive, penalizes success, and deters economic development. High marginal tax rates on capital gains income provide a disincentive for entrepreneurs and managers to move to Montana, or provide an incentive to move to another state when businesses and farms sell in order to avoid the capital gains tax. The tax structure should not be used for income redistribution, or to engineer social policy.

- To address these issues the state should consider additional individual income tax reform that provides for a single tax rate, coupled with increased personal exemptions and standard deductions that protect Montana’s lowest income households; or couple Montana’s individual income tax to federal tax liability using a single tax rate. Both of these approaches would greatly simplify the tax structure by eliminating the ability of two-earner married couples to file separate tax returns, could preclude the need to itemize deductions for many taxpayers, and would reduce administrative costs associated with the tax.

The Tax Reform Study Committee was provided with a report that addressed the implications of tying state tax liability to either federal taxable income (FTI) or federal tax liability (FTL), rather than to federal adjusted gross income (FAGI) as is done today. Major implications included:

- income tax filing and administration would be greatly simplified as taxpayers would no longer file separate tax returns, and many taxpayers would no longer have to itemize deductions;
- simplification has been shown to enhance tax compliance;
- tying to FTI or FTL would remove as many as 40,000 low-income taxpayers and households from the tax rolls, as taxpayers would be provided with greatly increased personal exemptions and standard deductions;
- reform proposals of this nature may involve thousands of “winners” and “losers,” which has been a difficult obstacle for past legislatures to overcome; and
- tying to either FTI or FTL generally tends to reduce state autonomy with respect to the individual income tax, and likely would subject the state to a greater instability in
the revenue stream from this source as the federal government makes frequent policy changes to this particular tax. This is evidenced by the observation that in recent years states have generally moved away from tying to federal tax liability (narrow base) to either federal taxable income or federal adjusted gross income (larger tax bases).

This second viewpoint was accommodated somewhat by the finding that the state's general fund had received revenue that was about $77 million higher than anticipated at the end of fiscal 2004. This led to forecasts of a budget surplus of as high as $142 million at the end of the 2005 biennium, before taking into account any increases in revenue in fiscal 2005 above the original forecast provided in HJR2 during the 2003 Legislative Session. If fiscal year 2005 revenues also come in $70-75 million higher than the forecast, the budget surplus at the end of 2005 may very well exceed $200 million.

Of course, clouding the Tax Reform Study Committee's vision of the state's fiscal condition are the unknown impacts attending the outcome of the school funding lawsuit. Those impacts could require a very large increase in state funding in order to meet the findings of the court.

Finally, as part of their charge, the Tax Reform Study Committee spent substantial time examining current individual income tax credits. There appeared to be strong sentiment on the Committee that most, if not all, of the tax credits should be eliminated. Committee members noted that many of these credits are seldom used; and that many are designed to provide for social engineering, a task better left to other means. Notwithstanding these discussions, the Committee did not act to formally make any recommendations to either retain or eliminate any of the current individual income tax credits.
Corporate License Tax

The general structure of Montana's corporation license tax has not changed for several decades. While the Montana Legislature has made minor modifications to certain aspects of this tax, the basic structure has not changed over time. Most of the changes to this tax by the Montana Legislature include the addition of new tax credits over time.

The corporation license tax was one of the least discussed taxes during the Tax Reform Study Committee's deliberations on Montana's tax structure; practically speaking, there were no public comments addressing this tax.

The committee was provided with a presentation on the essential aspects of the corporation license tax, which included the following major points:

- The starting point for Montana's corporation license tax is federal taxable income.
- Corporations make several Montana-specific additions to and subtractions from federal taxable income to arrive at adjusted federal taxable income for state tax purposes.
- For corporations operating in multiple states, adjusted federal taxable income must be apportioned to Montana using the traditional UDITPA equally-weighted, three-factor apportionment formula that takes into account the corporation's share of payroll, sales, and property in Montana.
- Apportioned income may be reduced for net operating losses (NOLs); these losses may be carried back for up to three years, or carried forward for up to seven years.
- The tax rate on Montana taxable income (after NOLs) is 6.75% (7% if the corporation is filing under the "Water's Edge" approach).
- A total of 20 different tax credits are available to corporations.
- Montana is a worldwide, combined unitary state, as opposed to being a separate accounting state.

Corporation License Tax - Minimum Tax

The only aspect of the corporation license tax that received a significant amount of attention during the Tax Reform Study Committee's discussions was the corporate minimum tax. Currently, corporations doing business in the state must pay a minimum tax of $50. This minimum must be paid for each subsidiary doing business in the state that is included in the corporation's consolidated filing. The committee heard and
discussed two alternative approaches for increasing the current law minimum tax. The details of these alternatives are discussed in the section of the report that presents the Committee’s recommendations and proposals for tax reform.

The Tax Reform Study Committee also examined all of the tax credits associated with the corporation license tax, but made no formal recommendations regarding these credits.
General Retail Sales Tax

General Discussion

Montana, along with four other states, has no general consumption tax. Past legislatures have considered several alternative approaches to implementing a general consumption tax in Montana, including a general retail sales tax, a gross receipts tax, and even a value-added tax. Of these different forms of consumption tax, the most often discussed, and the only one discussed by the Tax Reform Study Committee, is the general retail sales tax. The Committee was provided with PowerPoint presentations on the Streamlined Sales Tax Project, issues surrounding the inclusion of services in the base of a sales tax, and issues surrounding the taxation of producer inputs in sales taxes.

This section focuses on the Tax Reform Study Committee's discussions of the more prominent aspects of this form of general consumption tax. The use of a general retail sales tax to provide for comprehensive tax reform is discussed in the section of this report on comprehensive tax reform proposals.

Regressivity

One of the primary concerns with a general retail sales tax is the perceived regressivity of this form of taxation. A tax is considered regressive if the share of household income paid on the tax decreases as incomes rise.

In the past, studies of the regressivity of sales taxes relied on the annual income approach, which measured sales tax paid as a share of current incomes in any single year. These studies supported the notion that the sales tax is a regressive tax. In large part, this is attributable to the fact that higher income households tend to save a greater portion of their incomes than do lower income households. Consequently, a larger share of income in high-income households is not subject to the sales tax thereby reducing the effective tax rate for these households relative to lower income households, where most, if not all, income is spent.

More recent studies have incorporated the "lifetime incidence approach" to studying the regressivity of the sales tax. Under this approach, tax burdens are not related to current or annual incomes, but instead are related to an estimate of lifetime incomes of the household. This approach holds that studies using the annual approach fail to take into consideration that in any particular year incomes of many low-income households are temporary in nature, and do not reflect long-term household consumption patterns. In these studies, sales tax liabilities are related to consumption expenditures as a proxy for lifetime earnings capacities. Studies of the regressivity of the sales tax using the
lifetime income approach are frequently criticized on the grounds that there is no hard evidence that current consumption represents a good proxy for lifetime income.

While the lifetime incidence approach has provided evidence that the annual income approach overstates the regressivity of the sales tax in the long term, there remains no general consensus that sales taxes are not regressive, but do appear to be less regressive than otherwise thought to be when examining the regressivity of the tax from an annual income perspective.

There are many policy options available for reducing the regressivity of the retail sales tax, and perhaps even eliminate the regressive aspect of the tax altogether. There is general agreement, for example, that exempting food purchases and other items that comprise a substantial part of low-income household budgets acts to make the tax less regressive, whereas including in the tax base a large number of services, particularly services consumed in large part by high-income households, acts to make the tax more progressive.

Perhaps the most potent option available to policy makers to mitigate the regressive aspect of sales taxes is to provide rebates of sales taxes to low-income households. This can be done in a variety of ways. In Montana, the most common method of providing a low-income rebate of sales taxes in past comprehensive reform proposals has been through a refundable credit against the individual income tax. Generally, these proposals provide either a fixed dollar amount of credit based on the number of persons in a household, or a flat dollar amount of credit per-household regardless of the number of persons in the household. The credit amount is then phased out as household incomes increase to a point where no credit is allowed above a selected income level.

Many on the Tax Reform Study Committee believe that any proposal for comprehensive reform that includes a general retail sales tax must also include a component providing for rebates of a portion or all of sales taxes paid by low-income households. Low-income sales tax rebates have historically been included in most comprehensive tax reform proposals considered by the Montana Legislature.

Others on the Tax Reform Study Committee believe that rebates may not be an essential component of comprehensive reform if the tax base of the retail sales tax exempts a sufficient number of goods and services that make up the bulk of low-income households' budgets (food, rent, utilities, etc.), and if sales tax revenue is used to provide for individual income tax relief and/or property tax relief to low income households. Property tax relief may or may not include a refundable tax credit for low-income renter households.
Streamlined Sales Tax Project

Among the most complex aspects of taxation are the legal issues pertaining to nexus. In general terms, nexus refers to the ability of a given state to legally tax a particular entity or activity in light of statutory and constitutional guidelines and restrictions. In particular, before nexus can be established conditions must be met that satisfy both the Due Process and Commerce Clauses of the US Constitution. Nexus issues abound in sales taxation, and frequently relate to the taxation of interstate commerce; electronic commerce, or e-commerce (Internet sales, for example); and other remote sales such as mail order or catalog sales.

For a retail sales tax to operate efficiently and minimize economic distortions, all forms of consumption should be taxed, including the use of services and goods obtained from remote sellers. Court decisions to date have provided guidance on nexus issues, but have not completely resolved these issues as they relate to remote sellers. In National Bellas Hess, Inc. v. Illinois Department of Revenue (Bellas Hess), the courts established the physical presence standard, which essentially says that out-of-state businesses establishing a physical presence in a state have established nexus and are subject to the tax laws of that state. In Quill Corporation v. North Dakota Department of Revenue (Quill) the North Dakota Supreme Court held that in the absence of physical presence nexus could be obtained if the out-of-state business established an economic presence within the state, manifested primarily through exploitation of the state’s marketplace.

The US Supreme Court overturned Quill finding that even though the economic presence standard did not violate the Due Process clause, it failed to satisfy the Commerce Clause in that it would ultimately result in an undue burden being placed on interstate commerce. Previously, in Bellas Hess, the Court noted that allowing one state to tax would allow virtually all states, counties, municipalities, etc. to tax. Businesses would be required to track applicable tax rates in virtually every jurisdiction across the country. The Court found these administrative requirements to be an undue burden on interstate commerce. Ultimately, the Court concluded that the issue is better left to the US Congress.

The Streamlined Sales Tax Project came about due to the desire by states to tax remote sales, particularly mail-order sales and Internet transactions, in order to maintain revenue, avoid erosion in the base of the sales tax, and provide equal treatment between "brick-and-mortar" retailers and remote retailers.

Currently, 42 states and the District of Columbia are involved in the project, with 32 states having passed legislation or executive orders authorizing participation. The Project is supported by key organizations including the Federation of Tax Administrators, the Multistate Tax Commission, the National Conference of Legislators, the National Governors Association, and various business associations.

The goal of the Streamlined Sales Tax Project is to provide for central administration of sales and use taxes in order to substantially eliminate the burden of complying with
these taxes for remote sellers. It is hoped that this will in turn spur Congress to pass legislation authorizing states to tax remote sellers.

The Streamlined Sales Tax Project is being implemented by having the states adopt as a component of their sales and use tax laws the Streamlined Sales and Use Tax Agreement (SSUTA). There are many provisions of the agreement that would act to reduce the burden on businesses selling in national markets. These include:

- Each state will provide for central administration of its state and local sales and use taxes.
- All local option sales taxes must adopt the same tax base as the state sales tax by 2006.
- States, acting together, will provide for a nationwide, online registration system for sellers. Each state will provide an online database associating tax rates with zip codes. Sellers using the centralized registration system will not be required to register with individual states.
- State and local sales tax structures will be simplified by reducing the number of tax rates allowed; adopting uniform definitions of taxable items, uniform sourcing rules, uniform procedures for notifying sellers of changes in tax rates, bases, and jurisdiction boundaries, and uniform sales tax administration rules and procedures. This does not require states to adopt the same tax base.
- Processing of sales taxes owed by multi-state national vendors will be done with "certified automated systems" provided by "certified service providers." Very large sellers may have their own proprietary systems certified.

Note also that entering into the SSUTA would not affect the ability of states to implement specific taxes outside the general sales tax arena; this would include resort community taxes, and selective sales taxes on tobacco, alcohol, and motor fuels, for example.

The Tax Reform Study Committee heard several presentations on the Streamlined Sales Tax Project, and spent considerable time discussing the project. During the 9th meeting of the committee on July 12, 2004 members voted unanimously to recommend that any sales tax written or passed would be compatible with the Streamlined Sales Tax Project.
Model Sales Tax Bill

The Tax Reform Study Committee agreed that with respect to comprehensive tax reform involving implementation of a general retail sales tax there are two major considerations:

- implementing a general retail sales tax by determining the tax rate, tax base, administrative provisions, effective date for the tax, etc., and
- deciding what to do with the revenue generated from a sales tax.

To facilitate discussion of comprehensive tax reform, the Tax Reform Study Committee decided that it would be appropriate to provide the Montana Legislature with a model sales tax bill. The model sales tax is intended simply to provide interested parties with the Committee’s view on the appropriate structure of a sales tax, and is not intended to provide any direction as to how revenues from the sales tax would be used.

The diffuse views among Tax Reform Study Committee members on how sales tax revenue should be used precluded any agreement on this issue. In particular, there was little agreement among Committee members on the extent to which sales tax revenue should be used solely to reduce property and/or income taxes, or be used to provide additional funding for government services.

Furthermore, inclusion of the model sales tax in this report does not imply that all of the Tax Reform Study Committee members support or endorse implementation of a general retail sales tax. Instead, the Committee finds that inclusion of a model sales tax may be helpful to those members of the Montana Legislature wishing to pursue comprehensive tax reform proposals that include implementing a sales tax.

The predominant work of the Tax Reform Study Committee in developing a model sales tax bill was directed towards establishing the base for the tax; that is, which goods and services would or would not be taxed under a sales tax. This was decided by examining the differences in the tax bases between the two major sales tax bills of the 2003 Legislative Session – HB749 (Peterson) and SB470 (Mangan) – and voting to either tax or not tax those goods and services in the model bill. In the end, the model sales tax bill developed by the committee provides for the following major exemptions from the sales tax:

- food, except for prepared food and food products sold through vending machines;
- housing and rent;
- health services, prescription and nonprescription drugs, therapeutic/prosthetic devices and medical equipment;
- educational services, including day care services;
- motor fuels;
- motor vehicles, except motor homes, with a manufacturer’s rated capacity of 1 ton or more;
utility services (including sales of natural gas, water, electricity, refuse collection, retail telecommunications services subject to the retail telecommunications excise tax, and most transportation services);

- insurance premiums and commissions;
- gambling; and
- most sales to or sales by the agriculture, mining, manufacturing, construction, and electric power generation sectors of the economy.

Other Key Points of Sales Taxes

During their discussions, the Tax Reform Study Committee noted the following other key points with respect to implementing a general retail sales tax in Montana:

- The state constitutional limit of 4% on a statewide general retail sales tax does not preclude additional sales taxes levied by resort communities, or other local-option sales taxes that could be implemented in the future.

- One national study found that in 1998 about 34% of total consumption expenditures were subject to state sales and use taxes (down from 39% in 1985). This is due, in large part, to the fact that services comprise a larger share of total consumption today than in the past, and because a lot of state sales taxes do not apply to services. Services comprised 41% of personal consumption expenditures in 1960 and 59% in 2000.

- Studies indicate that, nationally, about 40% of all states’ sales taxes fall initially on purchases made by businesses. Ultimately, these taxes are passed on to consumers in the form of higher prices; or to labor in the form of reduced jobs, compensation or benefits; or to the owners of the business in the form of reduced profits.

Costs of Administering a Sales Tax

The Tax Reform Study Committee was provided with the costs of implementing a general retail sales tax in Montana. Based on the latest information from the Department of Revenue, implementation costs in the first year would be $7-8 million. This includes initial system development costs of about $5 million, with the balance needed for personal services ($1-2 million), and equipment and operating expenses ($1 million). Personal services costs will depend in part on how the tax base of any sales tax is defined, and the estimated number of businesses that would have to register under the sales tax.

Annual on-going costs to administer the sales tax would be about $4 million, with the vast majority of this cost going to personal services.
Section 6

Comprehensive Tax Reform

Concepts and Issues
Comprehensive Tax Reform – Concepts And Issues

The concept of comprehensive tax reform means different things to different people. In this section, and throughout this report, comprehensive tax reform refers to proposals that would result in a major overhaul of the state’s tax structure. In particular, comprehensive tax reform means implementing for the first time in Montana a broad-based consumption tax that generates revenue sufficient to provide for substantial reductions in existing income and/or property taxes. Historically, these types of reform proposals have relied predominantly on the general retail sales tax as the consumption tax component; although on occasion the Montana Legislature has considered a broad-based gross receipts tax, and even a value added tax.

Within this broad concept of comprehensive tax reform, past and current efforts exhibit wide variation regarding the specifics of different proposals, especially with respect to how sales tax revenue is used. This section provides an overview and comparison of several recent comprehensive tax reform proposals, and further discusses some of the issues inherent in some or all of these proposals.

Recent Comprehensive Tax Reform Proposals

Recent comprehensive tax reform proposals include the bill sponsored by the Montana Association of Counties in the 1997 Legislative Session (SB258), and bills introduced by Senator Mangan (SB470) and Representative Peterson (HB749) in the 2003 Legislative Session. All of these bills have as their centerpiece implementation of a general retail sales tax. Generally, the sales tax components of these bills are very similar in that they all provide for a 4% tax rate (the maximum rate allowed by the Montana Constitution), vendor allowances, provisions for administration of the tax, etc.

Variations in the specific goods and services included in the sales tax base of each of these bills result in variations in the revenue that would be generated under each proposal. But the major differences in these bills is in how sales tax revenue would be used under each proposal. Following sections examine these differences.

Individual Income Tax

SB258 did not address or change the individual income tax.

SB470 would have reformed the individual income tax in a manner very similar to the reform provided for in Senate Bill 407 (2003 Legislative Session). The previous law 10-tier rate table (with rates ranging from 2% to 11%) would have been modified to a 7-tier
table with rates ranging from 1% to 6.9%; the full deduction for federal income taxes paid during the year would have been capped at $6,000 ($12,000 for married couples filing jointly); and the bill would have provided for a non-refundable credit against individual income tax equal to 2% of net capital gains income.

HB749 would have replaced the prior law 10-tier rate table (with rates ranging from 2% to 11%) with a single rate of 5.75%; would have provided for an exclusion from income of 50% of capital gains income; would have eliminated entirely the itemized deduction for federal income taxes paid; and would have increased the personal exemption from $1,840 to $5,740 beginning with tax year 2004.

Sales Tax Credit

As discussed in the general retail sales tax section of this report, one means of mitigating the regressivity inherent in retail sales taxes is to provide low-income households with a sales tax rebate or credit.

SB258 would have provided for a refundable sales tax credit against individual income taxes based on a dollar amount per person for each person in the household that qualified for a personal exemption under the income tax laws. The credit was equal to $90 for each qualifying person in the household for households with incomes up to $16,000. This credit was reduced and phased out entirely for households with incomes in excess of $23,000.

SB470 would have provided for a refundable sales tax credit against individual income taxes based on a flat dollar amount per household, regardless of the number of persons in the household. The credit was equal to $300 for each household for households with incomes up to $16,000; and was reduced and phased out entirely for households with incomes in excess of $35,000.

HB749 did not provide for a low-income sales tax credit or rebate.

Property Tax

SB258 would have provided for sweeping reform of the state’s property tax structure by (among other things):

- eliminating the classification system and setting taxable value equal to market value for all property;
- exempting most personal property and livestock from taxation (livestock has since been exempted from taxation);
- providing for a homestead exemption equal to 65% of the first $50,000 of market value of residential property;
- eliminating state mills levied for the University System (6 mills) and the state general fund (95 mills), county mills levied for school retirement and transportation, and mills levied to fund the BASE portion (80%) of a school district’s general fund budget; and
repealing the current law railcar tax, low-income property tax assistance program, and reimbursements to local governments for past reductions in business equipment taxes under HB20 and SB417.

SB470 would have provided individuals and businesses with a refundable property tax credit against individual income and corporation license taxes. The amount of the credit would be equal to the amount of property tax associated with the state’s 101 mills levied for the university system and school equalization, up to $20,000, multiplied by the ratio of the taxpayer’s Montana-source income to total income.

Under this approach, individual and business taxpayers with sizeable property holdings, but with little or no Montana source income, would be provided with a tax credit equal to a portion of their property tax bill associated with the 101 mills. Taxpayers whose income is derived totally within Montana would receive a tax credit equal to the entire amount of their property taxes associated with the 101 mills.

SB470 also would have repealed the current law Class 8 “trigger,” which phases out property taxes on business equipment once inflation-adjusted growth in Montana wage and salary income exceeds 2.85%.

HB749 provided for the same tax credits as SB470, but would not have limited the credit to $20,000 before apportioning the credit on the basis of Montana-source income to total income. Also, HB749 did not repeal the Class 8 business equipment tax “trigger.”

School Finance

SB258 would have fully funded 100% of school districts’ BASE budgets (80% of the district’s general fund budget), and 100% of school retirement and transportation schedules with sales tax revenue, thereby eliminating property tax mill levies for these items.

SB470 and HB749 would have fully funded 100% of school districts’ BASE budgets (80% of the district’s general fund budget). Current law HB124 block grants to schools would have been repealed.

Corporation License Tax

SB258 and SB470 did not address the corporation license tax.

HB749 would have provided for an exclusion of 50% of capital gains income from taxation for corporation license tax purposes.
Voter Approval / Contingent Termination Provisions

SB258 and SB470 would have provided that the reform proposal be submitted to the voters at a general election held in the fall of the session year in which the bill was passed.

HB749 provided for contingent termination on December 31, 2009 unless the Legislature referred a measure extending the sales and use tax laws to the electors at the November 2008 general election, and the electors approved the measure.

Comprehensive Reform – MACo Update

At the third meeting of the Tax Reform Study Committee, Gordon Morris, Executive Director of the Montana Association of Counties (MACo), provided a briefing paper that discussed MACo’s current position with respect to comprehensive tax reform. Underlying MACo’s position are the following four premises:

- comprehensive reform must be revenue-neutral with respect to taxes paid by Montanans – sales taxes paid by nonresidents can be viewed as new revenue;
- the proposal must provide significant funding for education;
- the proposal must result in a significant reduction in property taxes; and
- mechanisms must be put in place to insure that taxes do not creep back to previous levels.

It is also MACo’s contention that the sales tax must be very broad in nature, providing for extensive taxation of services, and with minimal exemptions provided primarily to address the regressivity of the tax.

With respect to the individual income tax, the reform provided by SB407 should remain in place, or a new approach providing for a flat tax should be considered. Taxes on capital gains should be restructured, and the impacts of eliminating the deduction for federal taxes should be examined.

The major impetus for the MACo proposal continues to be sweeping reform of the property tax. Mills levied for the university system (6 mills) and the state general fund (95 mills); county mills levied for school retirement and transportation; and mills levied to fund the BASE portion (80%) of a school district’s general fund budget should be eliminated. There should be debate of whether this is best achieved by eliminating mill levies, or by rebating property taxes paid through a credit mechanism against individual income and corporate license taxes.

All property should be taxed at full market value with consideration given to a uniform classification ratio for all property. There should be significant reductions in property taxes paid by Class 4 residential and commercial property owners through appropriate adjustments to homestead and comstead exemptions and taxable valuation rates.
Business equipment taxes are cumbersome and should be eliminated; but local governments should be reimbursed for the revenue reductions associated with phasing out this tax.

Finally, low-income taxpayers should be provided with a tax credit, or rebate of sales tax paid, to mitigate the regressive nature of the sales tax.

Comprehensive Reform – Representative Erickson Proposal

During the 2003 Legislative Session, Representative Erickson introduced HB765, which also would have provided for comprehensive tax reform. During the course of the Tax Reform Study Committee’s meetings, Representative Erickson presented a modified version of this proposal that included the following major elements:

- a 4% sales tax on all goods and services other than unprepared food, health and medical care, utilities, and fuel;
- a 50% reduction in residential property taxes by means of a tax credit on the Montana income tax return (the credit would be prorated on the basis of the taxpayer’s Montana-based income to total income); and
- a refundable tax credit of $200 per single individual or $400 per household.

Representative Erickson noted that this general proposal could accommodate several policy options including the following:

- providing the property tax credit for all residences or just the taxpayer’s primary residence;
- phasing out the refundable tax credit above some appropriate income level;
- providing for a tax credit against income taxes equal to 18% of the taxpayer’s property tax bill for commercial and ag land;
- increasing the current law elderly homeowner/renter credit for renters; and
- providing college students who stay in Montana after graduation with a tax benefit designed to assist in paying off their student loans.

In developing his proposal, Representative Erickson noted that his primary goals were to add stability to the overall tax structure by adding the third leg (sales tax) of the “three-legged stool” of taxation; ensure that sales tax regressivity is sufficiently addressed; provide additional funding for education; and provide residential property tax relief.
Issues in Comprehensive Tax Reform

Exportability and Net Wealth Implications

Past comprehensive tax reform efforts have generally been couched in terms of overall "revenue-neutrality." That is, revenue generated by the sales tax is fully offset by reductions in property and/or income taxes. Proponents of reform have argued that in this context Montanan's must be better off, as nonresident tourists and business travelers would pay a significant portion of the sales tax, resulting in a net reduction in total taxes paid by Montanans.

This simplistic view fails to take into account two factors. First, it is likely that nonresidents would share in any reductions in property and income taxes. Part-year and nonresident filers pay about 6.5% of the state's individual income tax. While little is known regarding the amount of property taxes paid by nonresidents, it is likely that they would also share in property tax relief.

More importantly, past discussions have largely overlooked the implications of comprehensive tax reform with respect to Montanans' federal tax liabilities. Since the federal Tax Reform Act of 1986, state sales taxes have not been deductible for federal income tax purposes, but state income and property taxes have been deductible. Consequently, it is likely that using new revenue from a sales tax to significantly reduce property or income taxes will act to increase Montanans' federal income tax liabilities. Depending on how comprehensive tax reform proposals are constructed, the attending increase in federal tax liabilities may result in a net reduction in wealth for Montanans, and policymakers should be highly cognizant of this possibility.

The extent to which federal taxes would increase in total for Montanans will depend on the precise manner in which taxes are changed under any particular comprehensive reform proposal. Reform proposals that use sales tax revenue to completely replace the state's individual income tax or residential property tax would very likely result in a reduction in Montanans' net wealth. For example, over the three-year period 1999-2001, it is estimated that eliminating the state's individual income tax would have increased federal income tax liabilities an average of $117 million; eliminating residential property taxes would have increased federal income tax liabilities an average of $38 million.

The negative impact on Montanans' federal liabilities from eliminating the state's individual income tax is much larger than from eliminating residential property taxes for two reasons:

First, Montanans pay considerably more in state income taxes than they do in residential property taxes, and the amount of state income tax deducted on federal returns is more than double the amount deducted for residential property taxes.
Second, a much larger share of state individual income taxes is deducted for federal purposes relative to residential property taxes. Federal data indicate that federal deductions for state income taxes comprise about 90% of state income tax liability, but federal deductions for residential property taxes are a much smaller 66% of state residential property taxes.

This occurs for a couple of reasons. Because federal standard deductions are so large, taxpayers who itemize for federal tax purposes (just 32% in Montana) tend to be concentrated in higher income brackets. In addition, Montana's individual income tax is highly progressive with the top 10% of taxpayers paying more than half the tax liability; but the residential property tax is much less progressive with much of the tax paid by taxpayers and households in lower income brackets that utilize federal standard deductions.

In general, when considering the exportability and net wealth aspects of any reform proposal, policymakers should be guided by the following general principles:

- Any reform proposal that substitutes a sales tax for individual income and/or residential property taxes will increase Montanans' total federal tax liability, thereby eroding the net wealth position of Montanans. This is because individual income and property taxes are deductible for federal individual income tax purposes, whereas sales taxes may not be.

- Concentrating tax relief on the residential property tax, rather than on the individual income tax, is likely to have a much smaller impact on reducing the state's exportability position and the net wealth position of Montanans. This is because residential property taxes in total are significantly less than individual income taxes; because they are distributed more toward the lower end of the income scale; and because a much smaller proportion of taxpayers itemize deductions for federal income tax purposes at the lower end of the income scale.

- Concentrating tax relief at the lower end of the income scale, rather than at the high end of the income scale, is likely to have a much smaller impact on reducing the state's exportability position and the net wealth position of Montanans. That is because a much smaller proportion of taxpayers itemize deductions for federal income tax purposes at the lower end of the income scale.

- Concentrating tax relief on the individual income tax combined with concentrating relief at the high end of the income scale is the least optimal option vis-à-vis the state's exportability position and the net wealth position of Montanans. That is because the state individual income tax is highly progressive, with the vast majority of the tax paid by higher income households; and because a much larger proportion of higher income households itemize deductions for federal income tax purposes.
The above discussion provides policymakers with very broad and general implications associated with using sales tax revenue to reduce property and/or income taxes in Montana. While policymakers need to be aware of these implications, they should also be aware that these implications are tempered by many other factors, two of which are discussed here.

First, the above discussion assumes that the full amount of sales tax that is not paid directly by nonresident visitors and business travelers would be born entirely by Montana consumers in the form of higher prices. It is likely that this assumption greatly overstates the sales tax burden that will actually be borne directly by Montana consumers. Studies indicate that nationally about 40% of all states’ sales taxes fall initially on businesses. Tax incidence studies conducted in other states indicate that a significant portion of the tax paid initially by business will be exported to out-of-state owners of Montana businesses and out-of-state purchasers of products made in Montana.

Second, one feature of the federal American Jobs Creation Act of 2004 may have an impact on the net wealth implications of comprehensive tax reform, depending on when comprehensive reform can actually be achieved in Montana, and whether the new federal provision will be extended beyond its current 2-year sunset date. The new federal law provides that taxpayers may elect to deduct either their state sales tax or their state income tax, but not both, for federal income tax purposes.

The extent to which this would change the net wealth implications discussed above is unclear and requires further empirical analysis, but this provision is not likely to change the above conclusions significantly. First, it has no impact on the implications relating to property taxes. Second, reductions in state individual income taxes arising from comprehensive tax reform would likely not result in income tax liabilities being smaller than sales tax liabilities for the vast majority of taxpayers currently deducting state income taxes for federal purposes. In this event, the election to deduct sales tax in lieu of income tax would not affect the general outcomes discussed above.

Furthermore, the federal election to deduct state sales tax in lieu of state individual income tax has been made available only for tax years 2004 and 2005, and in all likelihood would have to be extended in order for it to impact the net wealth implications discussed above for Montanans under any comprehensive tax reform proposal implemented in coming years.

Nevertheless, it is clear that there is room for further empirical analysis to more fully and precisely understand the implications that comprehensive tax reform has regarding the net wealth position of Montanans.

Depending on how it is done, comprehensive reform that replaces property and/or income taxes with sales tax may result in a net reduction in Montanans’ net wealth. However, policymakers, guided by an objective evaluation of the current tax structure,
may well decide that an erosion of exportability is not an inappropriate price to pay in order to:

- balance the state’s tax structure through the use of all three legs of the traditional tax stool – income, property, and sales taxes;
- increase stability, sufficiency, and certainty to the overall tax structure through an appropriately constructed general sales tax;
- improve the state’s responsiveness to interstate competition by enhancing the state’s business climate and improving the state’s competitive position regarding economic development; or
- facilitate compliance and add simplicity to the system.

**Eliminate 101 Mills v. Tax Credit for 101 Mills**

One component common to recent comprehensive tax reform proposals is to provide property tax relief from the 101 mills levied statewide for the university system (6 mills) and the state general fund (95 mills for school equalization). The Tax Reform Study Committee heard and debated two separate approaches to providing property tax relief from these mill levies.

The first approach would simply repeal these mills, reducing all property taxpayers’ liabilities by 101 mills, or by $180-190 million, annually.

Under the second approach, taxpayers would be allowed a refundable tax credit against income tax for the amount of property tax associated with the 101 mills, prorated by the ratio of the taxpayer’s Montana-source income to total income for individuals; for multi-state corporations operating in Montana, the credit would be prorated using the corporation’s apportionment factor used for corporation license tax purposes.¹

For individual income tax purposes, full-year residents are taxed on the basis of their total income. In the vast majority of cases, the ratio of Montana-source income to total income for these taxpayers is equal to one. Consequently, most full-year residents would be allowed a refundable tax credit equivalent to the amount by which property taxes would be reduced if the 101 mills were eliminated.

Part-year and nonresident income tax liabilities are based on the ratio of Montana-source income to total income, and for these taxpayers in nearly all cases this ratio will be less than one. Consequently, part-year and nonresidents would be allowed a tax credit equal to a portion of the amount by which property taxes would be reduced if the 101 mills were eliminated.

¹ With refundable tax credits, taxpayers receive a check for any amount by which the tax credit exceeds their income tax liability. Full-year resident property taxpayers with no individual income tax liability would receive a check from the state for the full amount of property tax associated with the 101 mills.
Similarly, corporations with operations entirely in Montana would receive a credit equal to the amount of their property tax associated with the 101 mills, but multi-state corporations would receive a credit equal to just a portion of that amount.

**Constitutionality**

It is clear that under the credit approach to providing tax relief from the 101 mills that nonresidents and multi-state corporations would, in many cases, receive a much smaller benefit relative to simply eliminating these mills. The Tax Reform Study Committee expressed concern with the constitutionality of the credit approach and requested a legal opinion on the matter.

A provisional legal opinion was provided by Dave Ohler, Chief Legal Counsel for the Department of Revenue. After examining the proposed credit mechanism in light of equal protection provisions of the Montana and US Constitutions, property tax provisions of the Montana Constitution, and the Privileges and Immunities Clause in the Fourteenth Amendment to the US Constitution, Mr. Ohler noted that he could find no basis for concluding that the proposed credit mechanism would violate state and federal constitutional provisions. This finding, however, is predicated on the assumption that in devising the credits the Montana Legislature does so for reasons that propel a legitimate state interest, and not to simply discriminate between residents and nonresidents.

**Fiscal Impacts – State Treasury**

These two alternative approaches to providing tax relief from the 101 mills have very different impacts on the state treasury. Eliminating the 101 mills would reduce taxpayer liabilities and state revenue by $180-190 million, annually. Providing tax relief through a credit approach that requires prorating the credit by the ratio of the taxpayer's Montana-source income to total income would reduce taxpayer liabilities and state revenue by an estimated $120-130 million, annually.

Under the credit approach, taxpayers would continue to pay about $60 million per year more in taxes than if the mills were repealed entirely. While some of this would be paid by nonresident homeowners with little or no income in Montana, the majority of this difference would be paid by large, multi-state corporations, particularly utility companies, with significant in-state property holdings that derive a just a portion of their total income from Montana sources.

**Fiscal Impacts – Montanans' Federal and State Income Taxes**

Eliminating the 101 mills will have an impact on Montanans' state and federal income taxes. Residential property taxes are deductible for state income taxpayers who itemize their deductions. Eliminating the 101 mills will reduce property tax liabilities, thereby reducing deductions for property taxes. This is estimated to increase state income tax liabilities by about $3.5 million per year for Montana residents. Because residential
property taxes are also deductible for federal income tax purposes, eliminating the 101 mills is estimated to increase Montanans' federal income tax liabilities by $9-10 million each year.

The Tax Reform Study Committee also examined the impact that eliminating the state 101 mills would have on corporations doing business in the state. This impact will depend on:

- the profitability of corporations operating in the state;
- the share of taxable property attributable to profitable corporations;
- the average federal marginal tax rate applicable to profitable corporations with taxable property; and
- the extent to which federal taxes paid by corporations operating in Montana are actually paid by Montanans (or exported to out-of-state residents).

Based on a study that combined property tax information with corporation license tax returns over the period 2001-2003, it is estimated that repealing the 101 mills would increase federal income taxes on corporations operating in Montana by about $8.3 million annually. What is not known is how this increase in liability will be shared between Montanans and nonresidents.

Because most of the impacted corporations are owned in large part by nonresidents, operate in many states, have a workforce spread throughout several states, and sell their products and services primarily in states other than Montana under a national pricing structure, it is likely that the vast majority of the increase in federal tax will be exported to nonresidents. Under a very conservative assumption that just half is exported, it is estimated that about $4.2 million of the increase in federal taxes from eliminating the 101 mills would be borne by Montanans annually.

Eliminating the 101 mills would also act to increase state corporation license taxes. This would occur because Montana ties to federal taxable income for state purposes, and federal taxable income would increase when the 101 mills are eliminated. This impact is likely to be fairly small (e.g., less than $1 million).

Still unknown is the impact of eliminating the 101 mills on state and federal tax liabilities of the many pass-through entities (S. corporations, partnerships, LLCs, etc.) operating in Montana.

**Fiscal Impacts – Tax Increment Financing Districts**

Revenue for the operation of Tax Increment Financing Districts (TIFs) is derived from applying mill levies to the incremental value of property within the district. This includes the 95 mills levied for the state general fund. If the 101 mills are repealed, then revenues to TIFs to service bonds and provide direct funding for infrastructure and other projects would decrease by about $3.3 million per year. At issue is how this revenue would be replaced should the 101 mills be repealed. Options include direct
reimbursement from the state general fund to TIFs, or additional mills levied by local governments to supplement TIF revenues.

Other Considerations

There are advantages and disadvantages to each of the approaches to providing property tax relief associated with the 101 mills. Some believe that for comprehensive tax reform to be successful, the voting populace must be shown that the state is eliminating some other form of taxation. Completely repealing the 101 mills would eliminate all property tax levies at the state level, thereby removing the state completely from the property tax arena. Providing a tax credit for the 101 mills would likely not be viewed as eliminating a tax.

Taxpayers are also concerned that, following comprehensive tax reform, lawmakers could simply reinstate any taxes eliminated initially in the reform proposal in future years. This fear could easily be addressed under the approach of eliminating the 101 mills if it were written into the Montana Constitution that the state is prohibited from levying property taxes. Under this approach there also are no issues pertaining to the administration of the tax.

Under the credit approach, it may be more difficult to convince taxpayers that the property tax will not be reinstated in future years, or that the tax credit would not be tampered with in future years. The credit approach also would require additional administration of the tax system. Taxpayers would have to understand how the credit works and be provided with information that allows them to clearly and easily ascertain the amount of their property tax bills that is attributable to the 101 mills. Tax forms would have to be developed to provide for the credit against income taxes, and additional auditing efforts would be required to ensure taxpayer understanding and compliance.
Committee Recommendations and Tax Reform Proposals

- Comprehensive Tax Reform
- Tax Reform Proposals Providing for Revenue Enhancement
- Tax Reform Proposals Addressing Specific Issues
Committee Recommendations and Tax Reform Proposals

The Tax Reform Study Committee did not formally vote on any specific proposals or recommendations to provide for tax reform in Montana. The committee agreed that there are many options and approaches to reforming the state’s tax structure, and that it would be appropriate for the committee to provide the Montana Legislature with a menu of the various proposals and recommendations that were discussed during the course of the Committee’s deliberations.

The Tax Reform Study Committee also wishes to make it clear that not all members of the Committee agree with or support all of the proposals presented in the following sections. As with individual members of the Montana Legislature, and individual taxpayers or business organizations, there are proposals that individual members of the Committee agree with and support, and there are proposals that individual members of the Committee do not agree with or support.

For purposes of this report, specific proposals and recommendations discussed by the Tax Reform Study Committee are categorized into three general groups:

- Comprehensive Tax Reform
- Tax Reform Proposals Providing for Revenue Enhancement, or
- Tax Reform Proposals Addressing Specific Issues.

In many cases, Tax Reform Study Committee members advocating specific proposals in the latter two categories acknowledged that the proposal likely would not survive politically if it had to stand alone. In these instances, the proposals were advanced with the understanding that it should be included at some point as a component of a more comprehensive tax reform package. Proposals of this nature will be designated as such in the detailed discussions that follow.

**Comprehensive Tax Reform**

Comprehensive reform proposals, as defined here, include proposals that implement a broad-based consumption tax (e.g., a retail sales tax) and use the revenue from that tax to substantially reduce existing property and/or income taxes.

The Tax Reform Study Committee discussed and advanced just one comprehensive reform proposal during their deliberations. This proposal was sponsored by two committee members – Representative Peterson and Professor Myles Watts – and
essentially reflects the tax reform proposal introduced by Representative Peterson in the 2003 Legislative Session in House Bill 749\(^1\). This proposal includes the following elements:

### Retail Sales Tax

This proposal would implement as soon as practical a general retail sales tax at a rate of 4%. The retail sales tax component adheres to the model sales tax recommended by the Tax Reform Study Committee, covers both goods and services, and provides for the following major exemptions from tax:

- food, except for prepared food and food products sold through vending machines;
- housing and rent;
- health services, prescription and nonprescription drugs, therapeutic/prosthetic devices and medical equipment;
- educational services, including day care services;
- motor fuels;
- motor vehicles, except motor homes, with a manufacturer’s rated capacity of 1 ton or more;
- utility services (including sales of natural gas, water, electricity, refuse collection, retail telecommunications services subject to the Retail Telecommunications Excise Tax, and most transportation services);
- insurance premiums and commissions;
- gambling; and
- most sales to or sales by the agriculture, mining, manufacturing, construction, and electric power generation sectors of the economy.

In discussions of the sales tax, Representative Peterson stressed that it was his intent to exempt business inputs to as great an extent as possible to prevent pyramiding of the sales tax.

In addition, this proposal would repeal the tax increases on accommodations and rental cars that were enacted in SB407 (2003 Legislative Session).

### Sales Tax Rebate/Credit

Sales tax proposals frequently include a sales tax rebate or credit aimed at low-income households. This particular proposal does not address the perceived regressivity in sales taxes through this approach, however, but addresses regressivity of the sales tax by providing for exemptions of those items – food, housing, utilities, motor fuels, prescription and nonprescription drugs, and medical services – that comprise a significant portion of low-income household expenditures. Additional relief for low-income households is provided in the following proposed changes to the state’s individual income tax.

\(^1\) See the previous section on Comprehensive Tax Reform for a comparison of HB749 with other recent comprehensive tax reform proposals.
Individual Income Tax

Beginning January 1, 2007 Montana’s individual income tax would be restructured as follows:

- Current law tax rates ranging from 1% to 6.9% would be replaced with a single rate of 5.75%.
- The personal exemption would be increased from an estimated $1,960 in tax year 2007 to $5,990. Current law standard deductions would not change, but increasing the personal exemption by $4,030 would act to remove many low-income taxpayers and households from the tax rolls.
- The current law itemized deduction for federal income taxes paid during the tax year (capped at $5,000; $10,000 if filing a joint tax return) would be eliminated.
- Taxpayers would be allowed to exclude 50% of their capital gains income from tax. The current law tax credit equal to 2% of capital gains income would be repealed.

School Funding

Under this proposal, sales tax revenue would be used to fully fund the BASE budgets of school districts. BASE budgets comprise 80% of school districts’ maximum general fund budgets. The over-BASE portion of school districts’ budgets would continue to be funded using a combination of mill levies and other funding sources.

Property Tax Relief

This proposal would repeal the current 101 mills levied statewide for state purposes (6 mills for the university system, and 95 mills for school equalization). Because sales tax revenue, rather than property taxes and other revenue sources, will be used to fund the BASE budgets of schools, property taxpayers will be provided with an additional average reduction of about 63 mills, for a total average reduction of 164 mills statewide. This represents total property tax relief of nearly $300 million.

Companion legislation to this proposal would prohibit Montana from reimposing property taxes without the direct approval of the electorate.

Representative Peterson notes that an alternative to repealing the 101 mills and directly funding the BASE budgets of schools with sales tax, would be to provide property tax relief through a refundable credit against income taxes for property taxes associated with the statewide 101 mills and the BASE levies of school districts. This credit would be prorated on the basis of the taxpayer’s Montana-source income to total income.

Voter Approval

The property tax changes in this proposal take effect January 1, 2005; the sales tax would take effect January 1, 2006; and the individual income tax reform would take

During the Committee discussions of this proposal, Representative Peterson indicated his belief that Montana's tax structure is far too dependent on property taxes, does not match the structure of Montana's current economy, does not take a proactive stance towards economic development, and therefore requires immediate change. Furthermore, recent court rulings will require the Montana Legislature to address major school funding issues; issues that can be addressed in part through appropriate changes to the tax code.

Representative Peterson's goal is to provide a roadmap that can be used to achieve comprehensive reform that will provide for a more balanced tax structure, provide substantial property and income tax relief, and generate additional revenue from nonresidents visiting Montana through a retail sales tax. He views this proposal as a long-term commitment to statewide funding of education, to economic development, and to a tax structure that accommodates the current economy.

**Tax Reform Proposals Providing for Revenue Enhancement**

The Montana Legislature ended the 2003 Legislative Session anticipating a June 30, 2005 general fund ending fund balance of around $46 million.

Then, on April 15, 2004, District Court Judge Jeffrey Sherlock issued a decision in the matter of Columbia Falls Elementary District v. State of Montana finding that Montana's current system of funding schools violates state constitutional provisions. Specifically, Judge Sherlock found that schools are inadequately funded, and the state is not paying an appropriate share of the amount needed to fund schools. While the actual amount of funding that may be needed to resolve school funding legal issues continues to be a matter of speculation and debate, there is a generally held belief that these matters will not be resolved without substantial additional funding for schools.

The combination of a very small anticipated ending fund balance, coupled with the widespread perception that substantial additional funding may be needed for schools, led many on the Tax Reform Study Committee to develop and recommend proposals that either repeal existing statutes that substantially reduce revenue in coming years, or provide for additional revenue from new or existing sources.

Taken in combination, the following separate proposals could also be viewed as a means of providing comprehensive reform to address school funding and other public policy concerns.
Repeal the Current Law Class 8 Business Equipment “Trigger”

The issues surrounding the Class 8 business equipment trigger were discussed in detail in the Property Tax section of this report. There, it was noted that Senate Bill 200 (1999) provided for a “trigger” mechanism that would phase out the tax on business equipment, once annual inflation-adjusted growth in Montana wage and salary income exceeds 2.85%.

As of this writing, the earliest that the trigger could begin a phase down of the business equipment tax rate is tax year 2007; the first year in which the full fiscal impact would occur is fiscal year 2010.

*If the trigger is not hit*, property taxes levied on Class 8 business equipment are forecast to total $68 million in fiscal year 2010. Of this amount, $13 million would accrue to state mill levy accounts (6-mill university system levy and 95-mill general fund levy); $48 million would accrue to local governments and school districts; and $6.4 million would accrue to tax increment financing districts. *If the trigger is hit* and the phase down begins with tax year 2007, then revenues to these taxing jurisdictions will be reduced by these amounts in fiscal year 2010.

This proposal would repeal the current Class 8 trigger, thereby precluding potential future reductions in revenues associated with a phase out of business equipment taxes.

If the Class 8 business equipment trigger remains in place and is eventually hit, the Montana Legislature will have to address the following issues:

- Should the legislature reimburse local governments and schools for the revenue reductions that would occur; or would these taxing units “float” their mill levies and recoup the revenue from other types of property?
- Should the legislature reimburse tax increment financing districts for the reduction in revenue that would occur if and when the trigger is hit?
- To what extent would other personal property become exempt by virtue of eliminating property taxes on Class 8 business equipment?

If the trigger is repealed, these issues become moot.

Repeal SB407 Individual Income Tax Reform

The issues and fiscal impacts surrounding the individual income tax reform contained in SB407 were discussed in detail in the Individual Income Tax section of this report. There it was noted that the SB407 changes to the individual income tax were not made effective until tax year 2005. Those changes include:

- Reducing the previous 10-tier tax rate table (with rates ranging from 2% to 11%) to a 7-tier table with rates ranging from 1% to 6.9%.
Capping the previous full deduction for federal income taxes paid during the tax year at $5,000 ($10,000 if married and filing a joint return).

Implementing a new tax credit equal to 1% of capital gains income (this credit increases to 2% beginning with tax year 2007).

SB407 was estimated to reduce individual income tax collections by $92 million in the 2007 biennium. This proposal would repeal the individual income tax provisions of SB407, thereby precluding an estimated $92 million reduction in state general fund revenues during the 2007 biennium.

**Implement a “Pop Tax”**

This proposal would provide additional funds for government programs by instituting for the first time in Montana a tax on soft drinks. Commonly referred to as the “pop tax”, a soft drink tax could also apply to other types of drinks including certain juices made in part from fruit.

A soft drink tax is not a new concept; neither in Montana nor around the country. The June 2000 edition of the *American Journal of Public Health* noted that 18 states and one major city levied special taxes on soft drinks. HB360, introduced during the 1993 Montana legislative session would have provided for a tax on soft drinks. Two bills introduced during the 2003 legislative session – HB760 and SB433 – both included an excise tax to be paid by soft drink bottlers or importers.

Pop tax bills can take many forms depending on:

- where the incidence of the tax lies (bottler, importer, distributor, retailer, etc.);
- what types of drinks are subject to the tax (all “soft drinks”, pop, fruit juices, soft drinks containing milk or milk-byproducts, etc.); and
- the level of the tax rate, and what specific products tax rates are applied to (e.g., carbonated drinks and/or syrup concentrates).

The amount of revenue that would be generated from a pop tax proposal would also depend on these specifics. During the 2003 Legislative Session it was estimated that the soft drink tax in HB760 – where the tax was levied at a rate of $1.50 for each gallon of syrup or simple syrup sold, and 25¢ per gallon of bottled soft drink sold – would raise about $13-14 million per year. The soft drink tax in SB433 – where the tax was levied at a rate of 5¢ per each 12 fluid ounces of soft drink sold – was estimated to raise about $19-20 million per year.

Previous soft drink tax proposals rarely, if ever, provide for depositing the associated revenue in the state general fund, but instead provide for depositing the revenue in state special revenue accounts to be used for specific purposes. Revenue from the soft drink tax in HB760 would have been used to provide for scholarships for higher education; revenue from the soft drink tax in SB433 would have been used primarily to provide services for older Montanans.
During their final meeting, the Tax Reform Study Committee heard testimony from a representative from the American Association of Retired Persons (AARP) who indicated that a soft drink tax had been developed by the Aging Services Network, which includes the Governor’s Council on Aging; directors of senior centers across the state and representatives of the ten state area agencies on aging; and the Montana Senior Citizens Association. This broad coalition endorsed a pop tax as a means of funding services for older Montanans.

Representatives of the Montana Beverage Association spoke in opposition to a pop tax, but indicated that they would not object to soft drinks being taxed under a general retail sales tax. It was their contention that if soft drinks were to be taxed at all it should be under the umbrella of comprehensive tax reform, rather than through a piecemeal process that targets selected groups or industry segments.

Other issues and concerns expressed by the public and committee members include:

- a pop tax is likely to be regressive in nature;
- a pop tax could be used to address health concerns that arise from the consumption of soft drinks - but these concerns would be addressed primarily through program expenditures using funds generated from a pop tax, rather than through decreased consumption stemming from a tax on soft drinks; and
- the appropriateness of targeting one group of taxpayers to provide funding for services used by a much broader or different group of taxpayers.

Provide for a Gross Receipts (“Big Box Store”) Tax

This proposal would provide additional funds for government programs by instituting for the first time in Montana a tax – commonly referred to as the “big box store tax” – on the gross receipts of certain large retail stores.

A big box store tax was introduced during the 2003 Legislative Session in SB332. As introduced, that bill would have taxed the gross receipts from sales of tangible personal property for each store location with sales in excess of $10 million. The first $10 million in sales would not have been taxed; the first $10 million in sales above this threshold would have been taxed at a rate of 1%; the next $10 million in sales would have been taxed at 1.5%; and sales in excess of $30 million would have been taxed at 2%.

As introduced, SB332 was estimated to generate about $60 million of revenue per year; but the amount of revenue from any proposed big box store tax will depend on several factors, including the final rate structure adopted, and the types of stores and products to which the tax would apply. For example, SB332 as originally introduced, exempted sales of vehicles, farm implements, and construction equipment; and was further amended to exempt coal, gas and oil, and electricity. There is a concern by some on the Tax Reform Study Committee that this tax should not apply in the case of grocery stores as well.
Proponents of this proposal testified that this tax is directed towards large, national retailers like Wal-Mart, K-Mart, Costco, Shopko, Home Depot, Target, and other nationally-operated, large retailers having stores with gross receipts that exceed a certain threshold. Proponents of this tax contend that the profit from big box stores is shipped out of Montana; that they typically hire workers on a part-time basis, at low wage rates, with minimal or no health care benefits; and they place locally-owned and operated businesses at a competitive disadvantage.

Proponents also argued that a tax of this nature would, for the most part, be exported to nonresidents because these large retail chains establish and rely on national pricing and advertising schemes; consequently, an increase in taxes paid in Montana would not be recouped through price increases just in Montana, but through the national pricing scheme established for all products sold by these businesses.

Another issue that arose in conjunction with this tax is how intermediate goods, or sales for resale would be handled. It is not clear whether these sales should be subject to the tax or not. If they are not included in the tax base, then how would these types of sales be identified and excluded administratively? How would sales of these goods be allocated between sales below the threshold exemption level and sales above that level?

Public testimony in opposition to the big box store tax suggested that this type of tax is a hidden tax, rather than a visible tax such as the retail sales tax; that owners of big box stores already pay corporate taxes on their share of profits allocated to Montana; and that taxes should be paid based on profit, whereas gross receipts taxes could result in paying taxes when there is no profit.

Increase Current Law Gambling Tax

Current Montana law provides for a video gambling machine tax equal to 15% of gross machine income from each video gambling machine. Gross machine income is the difference between the total amount of money that is deposited into a machine and the amount that is paid out in winnings from the machine. Under this proposal, video gambling machine taxes would be increased to provide additional revenue for government services.

Proponents of increasing video gaming taxes to provide for additional revenue referenced two bills from the 2003 Legislative Session that would have increased video gaming taxes – SB289 and SB309.

SB 289 would have decreased the video gaming tax to 10% of gross machine income for premises having five or fewer machines, and increased the tax to 30% of gross machine income for premises with six or more machines. This bill was estimated to increase video gaming revenues by about $38-40 million per year. (This revenue impact estimate does not take into account any behavioral response of machine owners. Specifically, it was argued that premises that currently operate just 6 or maybe
7 machines may find it economically advantageous to operate only 5 machines at the lower tax rate.)

SB309 would have established a graduated tax rate structure for video gaming machines whereby the first five machines on a premises would be taxed at a rate of 15% of gross income; the next five machines at a rate of 20% of gross income; the next five machines at a rate of 25% of gross income; and all machines in excess of 15 machines would be taxed at a rate of 30% of gross income. This bill was estimated to raise video gaming revenues by $17-18 million per year.

One of the technical concerns with this bill was how to determine, for premises with more than 15 machines, which machines represent the "first five machines", which represent the "next five machines", and so forth. How to make this distinction would have significant implications for the revenue that would be generated under this type of proposal. From the premise owner's standpoint, the first five machines would always include those machines that generated the most gross income, whereas machines above the first 15 machines would always include those machines that generated the least gross machine income.

Generally, proponents of increasing video gaming taxes argued that Montana's current rate of taxation on these machines is below national and regional averages, and that increasing the rate would not affect interstate competition.

Opponents of this proposal argued that interstate tax rates cannot be compared directly because in many cases the rate applies to a different tax base; or that in some cases the machines are owned and operated by the state and, consequently, there is no private sector concern; and in other states gambling is allowed only on Indian Reservations.

But in Montana the viability of many private sector drinking and gaming establishments is directly tied to the profitability of their gaming operations. Reducing the gaming profit margin by significantly increasing the tax on gaming would lead to some establishments closing, or would result in fewer persons being employed in this economic sector. In support of this argument, opponents provided a study conducted by the University of Montana, Bureau of Business and Economic Research that supported the contention that the profitability position of this sector of the economy is highly tenuous.

**Increase the Current Corporation License Tax Minimum Tax**

Currently, Montana's corporation license tax statutes provide for a minimum filing tax of $50, to be paid by every subsidiary operating in Montana under a consolidated corporate tax filing. Under this proposal the corporate minimum tax would be increased in order to generate additional revenue for government services. The Tax Reform Study Committee was provided with two options for increasing the minimum tax.
Under the first option, the current $50 minimum tax simply would be increased to a higher amount. Corporation license tax data indicate that over the 7-year period 1996-2002 the $50 minimum tax has generated an average of $448,400 per year, with very little variation around this amount from year to year. Based on these historic collections, the Tax Reform Study Committee was advised that every $50 increase in the minimum tax would generate an additional $448,400 per year.

Under the second option, corporations would pay a graduated minimum tax based on their total Montana sales as follows:

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<th>Total Montana Sales</th>
<th>Current Law Minimum Tax</th>
<th>Proposed Law Minimum Tax</th>
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</tr>
<tr>
<td>$10 - 25 million</td>
<td>$50</td>
<td>$500</td>
</tr>
<tr>
<td>$25 - 50 million</td>
<td>$50</td>
<td>$1,000</td>
</tr>
<tr>
<td>$50 - 100 million</td>
<td>$50</td>
<td>$2,000</td>
</tr>
<tr>
<td>&gt; $100 million</td>
<td>$50</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

A complete analysis of the impact that this option would have on revenue requires knowing the amount of Montana sales for every corporation operating in the state. However, only multi-state corporations that apportion income for state tax purposes are required to report Montana sales on corporate tax returns. These corporations comprise only about one-quarter of all corporations filing tax returns in Montana; hence, this analysis was applied only to those corporations.

Furthermore, about 70% of these corporations report Montana sales of less than $1 million and would not see any change in their minimum tax under this option. Alternatively, only about 30% of multi-state corporations would be impacted by the proposed change in the minimum tax. This results in an average increase in the total amount of minimum tax that would have been paid by multi-state corporations of just $230,000 over the 7-year period examined under this option.

Again, this impact does not take into account the three-quarters of corporations that file tax returns but are not required to report Montana sales on their tax return. When these corporations are included, the revenue impact is certain to be higher, but data allowing a precise estimate of the impact is not available.

* * * * * * * * * *

During the interim, and by the time that the above proposals providing for revenue enhancement had been developed and recommended, the forecast of the state's general fund ending fund balance had grown from an initial forecast of $46 million at the
end of the 2005 biennium to almost $300 million by the end of the 2007 biennium (before any increases in spending). How this dramatic change in the state’s fiscal condition will change the perceived need to provide for additional sources of revenue, or repeal existing laws that reduce revenue in coming years, remains a matter of debate for the 2005 Montana Legislature.

**Tax Reform Proposals Addressing Specific Issues**

Over the course of their meetings, there were several instances during which the Tax Reform Study Committee raised and discussed, or received public comment that addressed, particular concerns with the state’s current tax structure. Most of these concerns are limited in scope, and address specific sections of the tax code; some address matters currently in litigation. All of these concerns, which are discussed in the following sections, involve property taxes, natural resource taxes, or a combination of these two taxes.

**Property Classification Proposal**

Issues raised by the Tax Reform Study Committee pertaining to Montana’s property tax classification system were discussed in detail in the Property Tax section of this report. There it was noted that Montana’s property tax system is often viewed as both complex and imbalanced. Contributing to this is the current system of classifying properties. There are 11 classes of property with taxable valuation rates ranging from 0.35% to 100%.

Personal property owned by companies engaged in similar activities with the same equipment can have taxable value rates that are different by 4 times. A company with property in more than one county can have a rate that is 4 times greater than one with the same equipment operating in only one county.

Taxable valuation rates for some centrally-assessed businesses are nearly 4 times higher than those for residential and commercial property. Residential and commercial properties also receive a homestead or comstead exemption, and are valued every 6 years with increases in value phased in over the following 6-year period. Centrally-assessed properties receive no exemption, and are valued annually with no phase in for valuation increases.

This proposal would address these differences among property classes by incrementally moving all property towards a single classification rate. Components of this proposal include:

- Pipelines would be moved from Class 9 (12% rate) to Class 13 (6% rate).
Taxable valuation rates would be reduced as follows:

<table>
<thead>
<tr>
<th>Class</th>
<th>Current Law</th>
<th>Proposed Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class 1 - Mines Net Proceeds</td>
<td>100% of Net</td>
<td>3% of Gross</td>
</tr>
<tr>
<td>Class 7 - Rural Elec. Co-ops</td>
<td>8%</td>
<td>4%</td>
</tr>
<tr>
<td>Class 9 - Centrally-Assessed Utilities</td>
<td>12%</td>
<td>10%</td>
</tr>
<tr>
<td>Class 13 - Telecomm., Elec. Generation</td>
<td>6%</td>
<td>4%</td>
</tr>
</tbody>
</table>

It was acknowledged that this proposal would more easily be accommodated as part of a comprehensive tax reform proposal than as a stand-alone proposal. The fiscal impacts would depend on how this proposal is combined with other components of a comprehensive reform proposal.

**Increase the Current Law $5,000 Exemption for Class 8 Business Equipment**

Currently, taxpayers whose businesses have less than $5,000 in market value of business equipment are exempt from property taxes on that equipment. Taxpayers with more than $5,000 in market value of business equipment are taxed on all of their business equipment.

In lieu of a general reduction in the tax rate applied to business equipment, this proposal would increase the current law $5,000 exemption level to provide small businesses with property tax relief. The Tax Reform Study Committee did not recommend a specific level to which the exemption should be raised, leaving that debate to the Montana Legislature. The following table shows the estimated impact on revenue from alternative exemption levels, based on tax year 2003 mill levies and valuations.

<table>
<thead>
<tr>
<th>Class 8 Business Equipment</th>
<th>Estimated Impacts of Increasing the Current Law $5,000 Exemption Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposed Exemption Level</td>
<td>Estimated Impacts of Proposed Exemption Amount</td>
</tr>
<tr>
<td></td>
<td>Number of Affected Individual Taxpayers</td>
</tr>
<tr>
<td>$10,000</td>
<td>6,710</td>
</tr>
<tr>
<td>$15,000</td>
<td>10,721</td>
</tr>
<tr>
<td>$20,000</td>
<td>13,372</td>
</tr>
<tr>
<td>$25,000</td>
<td>15,367</td>
</tr>
<tr>
<td>$50,000</td>
<td>20,995</td>
</tr>
<tr>
<td>$100,000</td>
<td>25,333</td>
</tr>
<tr>
<td>All Exempt</td>
<td>29,722</td>
</tr>
</tbody>
</table>

For example, increasing the exemption level to $25,000 would remove 15,367 taxpayers from paying business equipment taxes; would reduce taxable valuation statewide by $5.6 million; and would reduced property taxes statewide by $2.8 million.
Revenues to state accounts would be reduced $567,000; and revenue to local governments and schools would be reduced $2.3 million.

**Address the Current Taxation of Pipelines**

As discussed in detail in the Property Tax section of this report, similar pipeline properties may be subject to widely disparate treatment for property tax purposes depending on the how those lines are classified for property tax purposes. The tax treatment of these pipelines is also the subject matter of at least three lawsuits currently in the courts in Montana.

To move towards resolution of these legal issues, this proposal would provide that all oil flow lines and natural gas gathering lines be classified as Class 8 business equipment and taxed at a 3% valuation rate. Inter-county “transmission” lines would continue to be taxed as centrally-assessed property at a 12% taxable valuation rate.

**Exempt Pollution Control Equipment**

This proposal would exempt pollution control equipment from property taxation.

Proponents of this proposal argue that Montana’s Constitution calls for the state to “maintain and improve a clean and healthy environment.” Often this is viewed as an enforcement provision. But appropriate tax policy can advance the goals of this constitutional mandate as well, by encouraging the use of technology to reduce emissions and improve air quality. Eliminating the property tax on pollution control equipment would remove a disincentive for investment in these properties.

This proposal is best accomplished within the context of comprehensive tax reform, and any fiscal impacts would depend on the overall tax reform package.

**Provide for a New Method of Taxing Bentonite Mines and Bentonite Royalties**

The Natural Resource Taxes section of this report presented in detail the issues involved in the current taxation of bentonite. In short, the Tax Reform Study Committee heard and discussed two issues relating to the current taxation of bentonite in Montana:

- the current tax treatment of bentonite, relative to the treatment provided in Wyoming, may very well cause bentonite producers to abandon Montana production and concentrate on production in Wyoming; and
- current statutes providing for a net proceeds approach to taxing bentonite are unclear and frequently result in litigation to resolve disputed net proceeds calculations.

To address these concerns, this proposal would change the manner in which bentonite production is taxed. It also would change the manner in which royalty payments associated with bentonite production are taxed.
**Mines Net Proceeds.** Rather than taxing bentonite on a net proceeds basis, this proposal would provide for a flat value per ton of bentonite mined based on the following declining schedule:

<table>
<thead>
<tr>
<th>Tons Produced</th>
<th>Taxable Value per Ton</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 100,000 tons</td>
<td>$7.00</td>
</tr>
<tr>
<td>Next 150,000 tons</td>
<td>$6.25</td>
</tr>
<tr>
<td>Next 250,000 tons</td>
<td>$5.50</td>
</tr>
<tr>
<td>500,000 tons and over</td>
<td>$4.50</td>
</tr>
</tbody>
</table>

Tax liability would be calculated by multiplying the number of tons produced in each of the above categories by the value per ton, and then summing the total value across categories. This total value would then be subject to local government and school district mills levied at the bentonite mine location.

Under this proposal determining the tax base for bentonite production by taxing on the basis of the number of tons produced multiplied by a fixed value per ton would remove all the ambiguity currently inherent in the net proceeds approach. Using this approach, bentonite would be taxed in the same manner currently used to tax talc, vermiculite, limestone, and industrial garnets.

**Royalties.** At some mine locations in Montana, the combined effective property and individual income tax rate on royalties associated with bentonite production is as high as 46%. Conversely, just across the border from these mines in Wyoming, royalties are not taxed at all. To provide an incentive for bentonite production to remain in Montana, this proposal also would change the property tax rate applied to royalties received from bentonite production. Under this proposal royalties would be taxed at a flat rate of 15% of the royalty amount paid. The resulting tax liability would then be distributed to taxing jurisdictions in the area where the associated bentonite mine is located on the basis of the relative mills levied by those jurisdictions.

As part of this proposal, neither the taxable value from bentonite production at mines, nor the taxable value of royalties would be subject to the current 101 statewide mill levies (6 mills for the university system, and 95 mills for the state general fund).

**Exempt Certain Processing Costs for Coal**

A new coal-fired generation facility that has passed the permitting process and is contemplated for construction near Roundup will use coal from the nearby Bull Mountain Mine. This coal will be "washed" prior to being used in the facility. Industry representatives suggested that the costs associated with washing this coal should not be included in the contract sales price used to determine the severance tax on this coal, as production costs at the Bull Mountain Mine are already very high.
Because coal severance taxes are based on the contract sales price of coal, this proposal would exclude from the calculation of contract sales price costs associated with washing, drying, or chemical alteration of coal prior to determining coal severance taxes.

Extend Tax Incentive Termination Date for New Electric Energy Generation Facilities

Senate Bill 508 (2001 Legislative Session) provided new tax incentives for the construction of electrical generation facilities and related delivery facilities (transmission lines). Among other things, that bill provided that facilities constructed after May 5, 2001 and before January 1, 2006 may be exempt from property taxation for a 10-year period (5-year period for oil or gas turbines) beginning on the date that construction commences. To be exempt from property taxation, the owner is required to offer contracts to sell half of the facility's output at a cost-based rate, including a rate of return not to exceed 12%, to customers for a 20-year period from the date of the facility's completion.

Industry representatives argued that the sunset date of January 1, 2006 did not allow ample time for the planning, permitting and construction process for new facilities, and requested that the sunset date be eliminated or extended.

At their July 12, 2004 (9th) meeting, the Tax Reform Study Committee moved and passed a recommendation that the Montana Legislature consider amending 15-24-3001(1), MCA to extend the sunset date by which this property tax exemption could be provided from January 1, 2006 to January 1, 2011.

Address Issues Pertaining to Current Coal Severance Tax Incentives

SB134 (2001 Legislative Session) provided that the tax rate applied to coal that meets the following conditions is one-third the normal rate (15-35-103, MCA):

- First, the coal must be used to produce electricity in an in-state, coal-fired power plant that was constructed after December 31, 2001 and before January 1, 2008.

- Second, the operator of the power plant must offer, for use within the state, the first half of power produced to Montana consumers at a cost set by the Public Service Commission that reflects the cost of production plus a reasonable rate of return.

There is a concern on the part of the Tax Reform Study Committee that the contractual provisions at 15-35-103, MCA, because they provide for a preferential treatment of Montana customers, would not withstand a legal challenge based on the Commerce Clause of the US Constitution. The Tax Reform Study Committee therefore recommends that the Montana Legislature contemplate amending 15-35-103, MCA to remove the reference to “Montana consumers,” and simply provide that half the power be provided at rates that reflect the cost of production plus a reasonable rate of return.