TAX FAIRNESS: ENSURING COMPLIANCE AND PROPERTY TAX EQUALIZATION

BIENNIAL REPORT •THE MONTANA DEPARTMENT OF REVENUE

Montana Department of
REVENUE

An Introduction from the Director of the Montana Department of Revenue

Tax Fairness—Equalizing Property Values and Ensuring State Tax Compliance

Woven into the Montana Constitution are two moral imperatives that are the foundation of modern democratic society: 1) a guarantee of individual human rights and 2) a commitment to equitable taxation. Without a guarantee of human rights, individuals cannot participate meaningfully and effectively in society. Without equitable taxation, citizens—acting as the body politic—cannot pursue their common goals through governmental action.

This second moral imperative—equitable taxation—substantially defines the role of the Department of Revenue in the life of the citizens of this state. It is the duty of the Department to ensure as much as possible within resources allocated to it that the tax laws of the state are applied fairly and equitably among all taxpayers. When the Department is successful, citizens and businesses will pay only the taxes properly assigned to them and not any additional taxes that belong to others. Further, if the Department ensures that the tax laws are equitably applied, the revenue intended to be paid under the law is more fully collected—and thus contributing to the fiscal stability of the state and broadening the policy choices available to the Legislature and Governor. Finally, maintaining the equity and integrity of the tax laws strengthens public confidence and trust in government.

The Department of Revenue fills its role in equitable taxation in two broad ways: 1) by equalizing the valuation of property under the law and 2) by ensuring proper compliance with state taxes. The Department determines the classification of property and assesses its value directly. In this regard, the quality of the Department's classification and valuation practices largely determines the degree of equity in property taxes. In contrast, state taxes are generally self-assessed by taxpayers, with the Department checking compliance and correcting instances of non-filing or underreporting after the fact. For state taxes, the initial quality of taxpayer filing combined with the effectiveness of the Department's compliance activities determines the degree of equity achieved.

In some areas of tax law, there is a blending of the two major means by which equity is achieved. Certain property taxes—those on business equipment, and on centrally assessed and industrial property—include elements of self-reporting. In these instances, the quality of taxpayer reports, the Department's compliance activities and its classification and valuation practices all combine to determine the degree of equity for these taxes under the law.

Property Equalization—the Major Revenue Goal of the Montana Constitution

The 1972 Constitutional Convention rejected the existing system of property taxation because property values set by elected local assessors were inequitable. Delegate Mick McKeon declared local assessment to be perhaps "the greatest evil we have in our system." He noted that "local assessors have exerted on them great pressures for favoritism . . ." The Constitutional Convention staff identified the two major problems of property tax administration as "underassessment and the lack of uniform assessment." The convention staff traced these problems to local assessors seeking to shift state property taxes to other counties, creating a need for more state aid for their local schools, currying favor with local voters, and other political objectives that undermined equitable valuation of property.

The convention made property tax equalization a centerpiece of the revenue and finance article of the new constitution. Beyond simply ending a system fraught with favoritism and untoward political objectives, the delegates also saw property tax equalization as serving the purposes of more equal funding of public schools and economic progress. On the latter point, Delegate Dave Drum stated that "if Montana is to go ahead, we are going to have to have equalization in the eyes of those who would like to either stay in Montana and invest money or those who would like to come to Montana and invest money, creating more jobs for our young people." Other delegates saw property equalization as a matter of simple justice and of conforming to the constitutional standard of equal protection of the laws for each citizen.

The Constitutional Convention established a state system of property appraisal to replace local assessment entirely. Through this statewide system, the delegates hoped that the valuation of property would be objective and independent of the pressures for favoritism and economic and political influences that had created an unfair system of property taxation.

State law reinforces this constitutionally required state system of valuation with a strong mandate to the Department of Revenue to achieve equity in property valuations. §15-9-101 (1), MCA, provides that:

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

The Department has worked hard to fulfill the promise of equity in property taxation made by the Montana Constitution and state law. After the reappraisal of property that took effect on January 1, 2009, the Department contracted for an independent review of its work by internationally recognized property appraisal experts. These experts found that the Department's appraisal of residential property on average statewide were set at 99.7% of actual sales value, and for commercial property assessments were 90.87 % of sales value. Any assessment with 90% to 110% of actual market value meets appraisal standards, which means that the 2009 reappraisal was highly accurate. (In contrast, a 1960 legislative study concluded that local assessors had set property values at only 28.7% to 31.7% of sales value.) In terms of uniformity, the independent review found the level of uniformity in the Department's appraisals to meet or exceed applicable statistical standards.

The Department also implemented in the 2009 reappraisal a new system of agricultural land valuation based on soil science—replacing an inequitable system dating back to the 1960s. The new system is a quantum leap forward in equity in the valuation of agricultural land productivity. Despite being a new system, the agricultural valuation process yielded the lowest level of appeals of any class of property.

With regard to centrally assessed property, or property that crosses borders, the Montana Supreme Court has from 1932 through the recent PPL Montana (2007) and PacifiCorp (2011) decisions found that the Department's appraisal practices are proper and equitable and arrive at market value for these types of property. While centrally assessed property owners often seek major reductions in their property values, the Supreme Court has sustained the Department's practices and values.

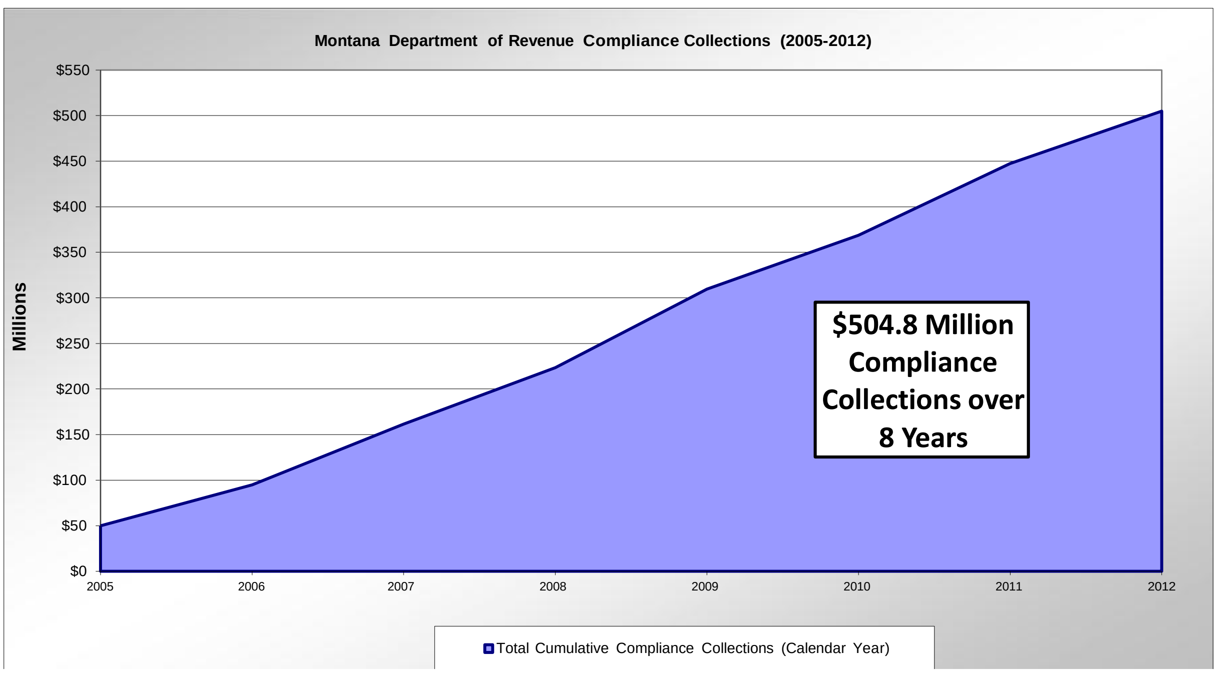
The Department also seeks to treat all property taxpayers as similarly as possible with regard to administrative procedures and dispute resolution practices. Doing so is an important component of achieving property tax equalization and of doing "all things necessary to secure a fair, just, and equitable valuation of all taxable property . . ." as a required by §15-9-101 MCA.

Compliance—Keystone to State Tax Fairness

Encouraging voluntary compliance and enforcing compliance when voluntary compliance falls short is the standard role of any tax agency. The gap between what the laws require in terms of taxes paid and what is actually paid is a measure of the inequity in the tax system. This gap is commonly referred to as the tax gap. The Department seeks to reduce this gap through a combination of methods including but not limited to: The Department's understanding of tax compliance challenges with regard to Montana state taxes is described below.

- taxpayer education programs, including making tax forms and instructions easier to read and understandable,
- practical information on its web site,
- support for tax preparers—both paid and volunteers—and additional technological support for volunteer taxpayer assistance,
- convenient taxpayer services such as a call center and online filing and payments services, continuing training and reinforcement of staff serving taxpayers professionally and with respect, and
- audit, enforcement and collection activities.

However, the Department is quite proud of its recent progress in achieving increased fairness in taxation through more effective and productive compliance efforts. Over the last eight years, the Department has generated direct compliance collections of over $500 million as indicated in the chart below. This half a billion dollars of accumulated revenue is more than the state's general fund balance.



In addition to the total dollars collected, the Department's efficiency has more than doubled. Before 2005, the Department collected $3.60 for each dollar spent on direct compliance. From 2005 through the present time period, the Department has collected $7.40 for each dollar spent on direct compliance.

Tax researchers suggest that the impact of direct compliance on increased voluntary compliance (referred to as the deterrent effect) exceeds the direct collection results by several times the direct collections. The Department of Revenue does not have a means of measuring this impact in Montana. However, if the deterrent effect is only twice that of direct collections, taxpayers have paid an additional $1 billion beyond the $500 million collected through direct compliance activities.

While compliance activities have begun to significantly close the tax gap, the relationship with taxpayers in the course of these activities has also improved. Beginning in 2008, the Department began surveying taxpayers audited by the Department and/or their tax preparers concerning the courtesy and professionalism of the Department's staff. In the initial year, the positive rating of the Department's compliance staff was above 60%—a very good result. However, the staff sought to improve their ratings. In years since, audited taxpayer ratings of Department staff have risen to a positive level of 85%. While compliance activities have increased, the relationship with taxpayers has also improved at the same time.

In terms of continuing compliance work, Internal Revenue Service research estimates the federal tax gap – or difference between tax owed and tax paid – at approximately 16.3% nationally. The Legislature has not funded comparable research to estimate a state tax gap. However, the Department's audit experience and selective study of particular problem areas suggests the following conclusions:

> Montana resident wage earners and retirees comply with state tax laws at a high level, estimated to be at 95% or above. This exemplary compliance rate is most likely due to a combination of factors including the existence of wage withholding, voluntary retirement withholding in some instances and third party reporting of typical retirement income.
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> The Department estimates that Montana-based businesses comply with state tax laws more fully than is the case nationally. Federal studies have determined the non-compliance rates nationally as high as 50% for small businesses. The Department of Revenue believes compliance is better by Montana businesses. However, business compliance is lower than the rate achieved by wage earners and retirees. This result most likely occurs because of less complete third-party reporting of income earned by businesses and investors.
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> The Department estimates that corporations underreport their Montana income by 10% to 15%. The result is that the Department of Revenue's active and continuing corporation tax audit program has been both necessary and highly productive over the years in correcting this underreporting.
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> Non-residents have very high rates of non-compliance. The Department estimates that this non-compliance rate is around 70%. Increased Department compliance activities combined with third party withholding for mineral royalty income have helped to reduce this level of non-compliance substantially. However, this area will remain a continuing challenge well into the future. The difficulties with regard to non-residents extend from fewer avenues of communication with both these taxpayers and their out-of-state preparers—to less information about their income from third parties and the IRS—to the absence of adequate withholding on income earned in Montana through property sales or business activities.

The Department of Revenue remains committed to ensuring the highest level of tax compliance possible, while protecting the rights of taxpayers and serving them with respect and professionalism. The Department continually adapts its work to changing circumstances, and in many areas is recognized nationally as a leader in administering state taxes fairly, efficiently and effectively.

Sincerely,

Dan Bucks, Director

Dan Bucks served as Director of the Montana Department of Revenue from 2005 to 2013.

Department Direction and Overall Results

The mission statement of the Montana Department of Revenue (DOR) describes what the agency strives to accomplish. The quality of life for all Montanans is better because we excel at public service and effective administration of the tax and liquor laws. We do this by:

- Ensuring that revenues intended by the legislature to be raised are collected to serve Montanans,
- Advancing equity and integrity in taxation,
- Providing effective and respectful service,
- Protecting the public health and safety, and achieving efficiency in liquor administration, and
- Improving public understanding of Montana's revenue system.

The DOR pursues this mission within the framework of our core values, which are rooted in the Montana Constitution. The values of the Department of Revenue are proven by human experience to lead an organization or community forward in a continuous positive manner. These core values include:

- Respect for all persons
- Integrity and justice
- Productivity and effectiveness
- Teamwork and community

Department Goals

1. To Serve Montana's citizens by respecting their rights, recognizing their dignity as individuals, and advancing public understanding of the tax system.

2. To advance equity and integrity in taxation by reducing gaps between taxes paid and taxes owed, and property classification and equalizing the value of all taxable property in the state.

3. To execute the timely and accurate distribution of funds, financial information, and valuation data to support the orderly operation and administration of Montana's complex intergovernmental tax and fiscal system.

4. To continually strengthen working relationships and understandings with other state agencies, local governments and school districts, tribal governments, the federal government, and the general public.

5. To protect the public health and safety in the consumption of alcohol by properly licensing alcoholic beverage entities, and efficiently distribution alcoholic beverages through a state controlled system.

6. To position the department to be prepared to manage various types of disasters.

7. To continually improve productivity, effectiveness, and quality of department services by developing competent staff, achieving management excellence, fostering teamwork, applying innovative practices and technology, responding to changing circumstances, and fulfilling the department's core values.

The duty of the DOR is to administer the revenue laws as defined by statute, set forth in title 15 of the Montana Code, with the exception of gasoline tax. The DOR is also responsible for administering the alcohol and tobacco laws set forth in Title 16 of the Montana Code.

Montana is one of two states that require their state revenue department to appraise all property within the state, in addition to administering the state income tax. This is in contrast to other states, where it is the individual cities and counties appraising property within their boundaries. The Montana Constitution requires the state to classify, appraise, and keep record of all property within the state. Montana law assigns this constitutional responsibility to the DOR. This approach promotes equity in valuation throughout the state.

Additionally, Montana statute (15-9-101, MCA) requires the DOR to adjust and equalize the valuation of taxable property between class of property, between counties, and between taxpayers to secure a fair, just, and equitable valuation of all taxable property.

After receiving the number of mills to be levied for each taxing jurisdiction, Montana statute (15-10-305, MCA) directs the DOR to compute and itemize the taxes, fees, and assessments to be levied on each property's tax bill.

These additional responsibilities place Montana's DOR in a unique position – in terms of its share of responsibility for state and local tax systems – compared to other states' revenue departments.