Briefing on Large Industrial Property Taxation
for the SJR 17 Study of Centrally Assessed and Industrial Property

Prepared for the Revenue and Transportation Interim Committee
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INTRODUCTION

The Senate Joint Resolution No. 17 (SJR 17) study has focused largely on centrally assessed property. The resolution also calls for a study of large industrial properties, which are assessed by appraisers located in Helena, and consideration of whether industrial property should be assessed locally.

This report covers the authority for industrial property taxation, methods for valuing industrial property, and how other states address industrial property taxation.

AUTHORITY FOR INDUSTRIAL PROPERTY TAXATION

Section 15-7-101 gives the Department of Revenue (DOR) the duty to classify and appraise all taxable lands. The statutory authority directly addressing industrial property is focused on classification of industrial property, the rate at which the property is taxed, and the commercial property tax exemption. Administrative rules contain some additional details and address specifics related to appraisal and valuation.

Defining and Classifying Industrial Property

"Industrial property" is not defined in statute but falls under the larger category of commercial property as that term is defined in subsection (1)(d)(i) of 15-1-101, MCA:

> (d) (i) The term "commercial", when used to describe property, means property used or owned by a business, a trade, or a corporation as defined in 35-2-114 or used for the production of income, except property described in subsection (1)(d)(ii).
> (ii) The following types of property are not commercial:
> (A) agricultural lands;
> (B) timberlands and forest lands;
> (C) single-family residences and ancillary improvements and improvements necessary to the function of a bona fide farm, ranch, or stock operation;
> (D) mobile homes and manufactured homes used exclusively as a residence except when held by a distributor or dealer as stock in trade; and
> (E) all property described in 15-6-135.

Rule 42.22.1301 of the Administrative Rules of Montana does define "industrial property" as "property used in the extraction, production, distribution, and changing the form of raw materials or assembling components and parts, packing and warehousing, and shipping the finished products." Examples of industrial property include oil refineries, sawmills, coal and metal mines, grain handling facilities, and other light manufacturing.

As part of the larger category of commercial property, industrial land and buildings are classified as class four property in section 15-6-134(1)(g) and taxed at 2.63% of taxable market value for tax year 2012. Industrial property is also eligible for the commercial property exemption in section 15-6-222. For tax year 2012, 19 % of the value of commercial buildings and land is not subject to taxation.

According to Rule 42.22.1305, manufacturing machinery and equipment is taxed as class eight property. Section 15-6-138 outlines the tax rates for class eight property. The first $2 million of taxable market value is taxed at 2% and taxable market value in excess of $2 million is taxed at 3%.[1] Beginning in fiscal year 2013, the tax rate for the first $3 million of taxable market value is reduced to1.5% if individual and corporation income tax collections exceed the revenue raised in the previous fiscal year by more than 4%.

VALUATION METHODS FOR INDUSTRIAL PROPERTY

Appraising Industrial Property

The statutes addressing industrial property appraisal are general in nature, with more detail contained in administrative rule. According to Rule 42.22.1315, industrial property is appraised by industrial appraisers located in Helena and the appraised values are distributed to local DOR offices. Section 15-7-107 requires a DOR commercial and industrial property appraiser to be certified in appraising commercial and industrial property. Rule 42.22.1316 contains additional detail about the coursework required for industrial property certification.

Rule 42.22.1309 gives industrial appraisers the discretion to "consider, based on generally accepted appraisal principles, the cost approach, the income approach, and the market approach to value, if the necessary information is available." A brief description of the three approaches follows:

- The **cost approach** determines the cost for a new replacement and deducts any loss in value from physical deterioration and depreciation. This approach is the only approach that can be used for all types of construction and is a starting point for appraisers. If market and income data are not available, this is the strongest approach.[2]
- The **income approach** measures the present value (or capitalized value) of the future net income expected to be generated by the property. This approach reflects economic trends in specific valuation areas and is based on the idea that the value of an asset depends on demand and demand depends on the profit the asset will generate.[3]
- The **market approach** uses the market value of equity and debt and comparable sales of like property to arrive at a value.[4]

[1]A business that owns $20,000 or less in market value of class eight property is exempt from taxation. Section 15-6-138(5).

[2]Department of Revenue, "Approaches Used to Determine Property Value," available from http://revenue.mt.gov/forindividuals/taxes_licenses_fees_permits/Property_Taxes/approaches.mcpx.

[3]Ronald C. Fisher, *State & Local Public Finance*, Mason, OH: Thomson South-Western, 2007.

[4]Montana Department of Revenue, "Centrally Assessed and Industrial Properties," slides for the Revenue and Transportation Interim Committee, Sept. 27, 2011.

Subsection (3) of the rule requires the Department to use the valuation that "most accurately estimates market value."

Valuing Improvements

Industrial improvements are defined in Rule 42.22.1301(2) as "all improvements upon the land, of a civil construction character, utilized to house the industrial process. All storage facilities shall be treated as improvements to land." Rule 42.22.1304 addresses valuation of industrial improvements and directs DOR appraisers to "use their best judgement to establish the effective age" of the improvements "by examining the condition, desirability and utility of the property." After determination of the age, the appraiser is to use the schedules in the 2002 Montana Appraisal Manual to depreciate the property on an age/life basis. The "Means" or "Marshall Valuation Service" cost manuals are acceptable if the property is not listed or not listed accurately in the 2002 Montana Appraisal Manual. In addition the rule allows DOR to apply the cost, income, and market approaches if appropriate.

Valuing Industrial Property Other Than Land and Improvements

According to Rule 42.22.1306, industrial property other than land and improvements is valued based on the cost to replace the property. That value is then depreciated on an age/life basis to account for deterioration and obsolescence. DOR may also apply the valuation approaches discussed above if adequate market data exists. Rule 42.22.1307 requires DOR to publish annually trend factors for industrial property other than land and improvements. The factors are from the Marshall Valuation Service, but a taxpayer can demonstrate instances in which another source of information provides more accurate information. The DOR publishes the trend factors in Rule 42.22.1311.

Rule 42.22.1308 also directs DOR to annually publish depreciation schedules for property other than land and improvements. The rates are intended to compensate for loss in value from ordinary wear and tear, offset by maintenance, and obsolescence due to technological changes during the life expectancy. These depreciation schedules are contained in Rule 42.22.1312.

Revaluation of Industrial Property

The revaluation of taxable property is addressed in section 15-7-111, which gives DOR the task of administering and supervising a program for revaluing taxable property in classes three, four, and ten, and requires all other property to be revalued annually. Industrial property is class four property, which is subject to a 6-year reappraisal cycle as provided in subsection (5). Rule 42.22.1315 outlines the 2008 industrial property reappraisal plan, requiring that industrial property be reappraised annually.

In practice, real industrial property (land and buildings) is valued on the same 6-year cycle as other class four property. However, DOR often reviews the property annually because of new construction. The personal property is valued annually and that value is combined with the phased-in value of the real property to arrive at the annual valuation of the industrial property.

OTHER STATES' INDUSTRIAL PROPERTY TAXATION

This section provides information about industrial property taxation in Montana's neighboring states: Idaho, North Dakota, Oregon, South Dakota, and Wyoming. Each of these states provides for assessment by the state Department of Revenue (or state equivalent) for certain properties but none, except Oregon, assess industrial property at the state level.

Like Montana, all of the states discussed below consider the cost approach, the income approach, and the market (or sales comparison) approach when valuing industrial property. All of the states also provide for annual valuation of industrial property.

Idaho

There are no special tax provisions for industrial property in Idaho. The Idaho State Tax Commission (Commission) values public utilities, railroad companies, and railroad car companies but all other property is appraised annually by local appraisers.[5]

Section 63-208 of the Idaho Statutes directs the Commission to establish and distribute rules "directing the manner in which market value for assessment purposes is to be determined for the purpose of taxation." Rule 35.01.03.217 of the Idaho Administrative Rules provides that the sales comparison approach (also known as the market approach), the cost approach, and the income approach will be considered on all property.

North Dakota

North Dakota has four classes of property that are identified in section 57-02-27:

- residential property;
- agricultural property;
- commercial, air carrier transportation, and railroad property; and
- centrally assessed property, except air carrier transportation and railroad property.

As is the case in Montana, industrial property falls into the larger category of commercial property. North Dakota commercial property is defined by process of elimination in section 57-02-01: it is property that is not agricultural property, not centrally assessed property, not railroad property, and not residential property.

All property is locally assessed by county assessors except centrally assessed property, which includes railroads, investor-owned public utilities, pipelines, and airlines.[6]

Market value for commercial property, including industrial property, is determined using the cost approach, the sales comparison approach, and income capitalization.[7]

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[5]CCH, "State Tax Guide: All States, Volume II," pp. 21,906 - 21,918.

[6]"Property," Office of State Tax Commissioner, available from: http://www.nd.gov/tax/property.

[7]North Dakota Office of State Tax Commissioner, "Property Tax Valuation Concepts - Residential and Commercial Property," July 2011, available from http://www.nd.gov/tax/property/pubs/guide/conceptsresidentialcommercialproperty.pdf.

Oregon

Oregon Administrative Rule 150-306.126(1) defines "industrial property" as:

> ...a facility or property engaged in manufacturing or processing which includes, but is not limited to sawmills, plywood and veneer plants, paper and pulp mills, food processing facilities, bakeries, flour mills, chemical processing operations refineries, breweries, wineries bottling operations, machine shops, metal rolling mills, metal fabrication facilities, smelters, printing and publishing operations, seed processing operations, permanent sand and gravel operations, and electronic and high technology manufacturing operations.

The Oregon practice with respect to the entity responsible for valuation of industrial property is similar to the Montana approach except that the Oregon Department of Revenue appraises only industrial property with a value of more than $1 million. Section 306.126 of the Oregon Revised Statutes defines "principal industrial property" as industrial property with a real market value of improvements for the previous year of more than $5 million. "Secondary industrial property" is industrial property with a real market value of improvements for the previous year of more than $1 million and less than $5 million. Subsections (1)(b) and (1)(c) of section 306.126 state that the Department of Revenue must appraise principal industrial property and secondary industrial property, respectively, and advise the county assessor of the real market and assessed value and the real market value of net improvements.

Oregon also allows the same approaches to valuation as those permitted in Montana Rule 42.22.1309, except that the owner of an industrial plant has the option of electing to have the property appraised excluding the income approach to valuation. According to section 308.48, an "industrial plant" includes any industrial real or personal property eligible for appraisal under section 306.126, discussed above.

Section 308.411 permits the use of the following approaches to valuation: "the market data approach (sales of comparable properties), the cost approach (reproduction or replacement cost of the plant) or the income approach (capitalization of income) or by two or more approaches." Subsection (2) gives the owner of an industrial plant the option to exclude the income approach to valuation. An owner who makes this election must choose one of the following:

- the owner is not required to provide itemization of income or expenses of the plant for use in making an appraisal of the plant for property tax purposes; or
- the owner is not required to provide itemization of income for use in making an appraisal of the plant but may be required to provide an itemization of operating expenses of the plant for use in measuring functional obsolescence in a market data approach or cost approach.

Section 308.411(6)(a) allows an owner making the election to exclude the income approach to revoke or revise the election prior to December 31 of the tax year in which the election applies.

All Oregon property, including the industrial property appraised by the Department of Revenue, is appraised annually by January 1.[8]

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[8] "How Property Taxes Work in Oregon," Department of Revenue, available from: http://www.oregon.gov/DOR/PTD/Pages/property.aspx.

South Dakota

Section 10-6-31 of the South Dakota Codified Laws lists the four classifications of property for property tax purposes: agricultural property, nonagricultural property, owner-occupied single-family dwellings, and nonagricultural acreage property. Industrial property falls into the catchall, nonagricultural property category. Unlike in Montana, industrial property in South Dakota is assessed locally.[9]

All real property in South Dakota is valued each year as provided in section 10-6-2. The same valuation approaches are used in South Dakota as in Montana: section 10-6-33 requires "appropriate consideration of the cost approach, the market approach and the income approach to appraisal."

Wyoming

Section 39-13-103 identifies the three classes of property in Wyoming and their taxable values:
- gross product of minerals and mine products, 100%;
- property used for industrial purposes, 11.5%; and
- all other property, real and personal, 9.5%.

This section also provides for annual revaluation of property.

Wyoming's definition of properties used for industrial purposes is broader than Montana's definition of industrial property. "Property used for industrial purposes" is defined in section 39-11-101(a)(xiv) and refers to the following properties listed in section 39-13-102(m):
- property of pipeline companies;
- property of electric utilities;
- property of railroad companies;
- property of rail car companies;
- property of other public utilities; and
- leased property consisting of warehouses, storage facilities and office structures and any other property that is in support of or which is used or held for use for the activities listed in this subsection.

Also designated as property used for industrial purposes in section 39-11-101(a)(xiv) are properties used or held for use for:
- manufacturing, milling, converting, producing, processing or fabricating materials;
- the extraction or processing of minerals; and
- the mechanical, chemical or electronic transformation of property into new products.

The Ad Valorem Tax Division of the Department of Revenue is responsible for valuing the properties referred to in section 39-13-102(m), some of which are listed above. The properties described in section 39-11-101(a)(xiv), which are more similar to Montana industrial properties, are valued at the county level.

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[9] The following sections of the South Dakota Codified Laws provide for central assessment of a pipeline company (10-37-9), a telephone company (10-33-11), a public service company (10-35-9), the flight property of an airline company (10-29-8), and the operating property of a railroad (10-28-7).

Chapter 9 of the Department of Revenue administrative rules for Property Tax Valuation Methodology and Assessment describe the methodologies used to determine the taxable value of property valued and assessed by county assessors. The allowed appraisal techniques include the sales comparison approach, the cost approach, and the income approach. The rule also provides that each approach should consider the nature of the property and the regulatory and economic environment within which the property operates.

CONCLUSION

Montana's practices related to the valuation of industrial property are similar to those of neighboring states. The valuation of industrial property centrally, by DOR appraisers is not common in the other states. Oregon's policy is similar to Montana's, though the Oregon Department of Revenue only values industrial property with a value higher than $1 million.

The Department of Revenue will present information about trends in industrial property valuation and taxation and the reasons for Helena DOR appraisers to value industrial property. After receiving this information, the Committee should consider the advantages and disadvantages of requiring Helena appraisers to value industrial property and the valuation methods used.

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