Revenue and Transportation Interim Committee

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59th Montana Legislature

SENATE MEMBERS
JIM ELLIOTT--Chair
GREGORY BARKUS
JERRY BLACK
KIM GILLAN
SAM KITZENBERG
KEN TOOLE

HOUSE MEMBERS
KARL WAITSCHIES--Vice Chair
JILL COHENOUR
CYNTHIA HINER
BOB LAKE
DAVE MCALPIN
PENNY MORGAN

COMMITTEE STAFF
JEFF MARTIN, Lead Staff
LEE HEIMAN, Staff Attorney
DAWN FIELD, Secretary

MINUTES

December 13, 2005

Room 137, State Capitol
Helena, Montana

Please Note: These are summary minutes. Testimony and discussion are paraphrased and condensed. Committee tapes are on file in the offices of the Legislative Services Division. **Exhibits for this meeting are available upon request. Legislative Council policy requires a charge of 15 cents a page for copies of the document.**

COMMITTEE MEMBERS PRESENT

SEN. JIM ELLIOTT, Chair
REP. KARL REP. WAITSCHIES, Vice Chair

SEN. GREGORY BARKUS
SEN. JERRY BLACK
SEN. KIM SEN. GILLAN
SEN. SAM KITZENBERG
SEN. KEN TOOLE

REP. JILL REP. COHENOUR
REP. CYNTHIA HINER
REP. BOB REP. LAKE
REP. DAVE MCALPIN
REP. PENNY REP. MORGAN

STAFF PRESENT

JEFF MARTIN, Lead Staff
LEE HEIMAN, Staff Attorney
DAWN FIELD, Secretary

AGENDA & VISITORS' LIST

Agenda, Attachment #1.
Visitors' list, Attachment #2.

COMMITTEE ACTION

The Revenue and Transportation Interim Committee adopted the revenue estimates prepared by the Legislative Fiscal Division and the Office of Budget and Program Planning.

CALL TO ORDER AND ROLL CALL

00:00:35 Sen. Elliott called the meeting to order at 8:00 a.m. Roll call was taken, all members were present.

00:01:35 SEN. ELLIOTT said that the Committee will meet on Friday, December 16, 2005, to review and comment of the gasoline tax revenue sharing agreement with the Rocky Boy Indian Reservation.

00:02:22 **Judy Paynter, Office of Budget and Program Planning, (OBPP),** said that the law specifies that the revenue sharing agreement must be presented to the Revenue and Transportation Committee for review and comment. Ms. Paynter said it is her opinion that the agreement must be reviewed by the Committee before it can be effective and that she would like it to be effective on January 1, 2006. She said it would take about ten minutes for review and comment.

REVISE SELECTED REVENUE ESTIMATES FOR THE 2007 BIENNIUM

00:04:23 **Clayton Schenck, Legislative Fiscal Analyst, Legislative Fiscal Division (LFD),** said that in the past, the Legislative Fiscal Division (LFD) and the Office of Budget and Program Planning (OBPP) both presented revenue estimate recommendations to the Revenue and Transportation Committee. He said the Committee has expressed its frustration with this method and that the two entities have worked together and will present only one recommendation. Mr. Schenck emphasized that the collaboration did not compromise the independence in arriving at the estimates. Mr. Schenck said the joint effort was a milestone in professional cooperation and while the LFD staff would be presenting the estimates, the contributions of both staffs was significant.

00:09:48 **Terry Johnson, Principal Fiscal Analyst, LFD,** presented the revenue estimate recommendations of revised general fund estimates for fiscal years 2006 and 2007 (EXHIBIT #1). Mr. Johnson said the full text of the report has been provided to the Committee members (EXHIBIT #2), as well as a one page summary of the recommendations (EXHIBIT #3), and Department of Revenue audit information (EXHIBIT #4). Mr. Johnson's presentation included discussion of:

- committee direction on September 30, 2005;
- review of fiscal 2005 recommendations;
- the revenue estimates for the December special session;
- the 2007 biennium general fund outlook; and

- the 2009 general fund outlook.

00:30:05 REP. LAKE asked if the major change in corporate profits for 2005 is at least partially due to the change of accounting in the accelerated depreciation schedule that was put into effect after 9-11. **Dan Dodds, Department of Revenue,** said that companies that took advantage of the bonus depreciation now have less depreciation, which translates into higher profits. Mr. Dodds noted that the bonus depreciation window occurred during a national recession when corporate profits were low anyway, and that they were artificially lowered even more by the change in accounting rules.

00:32:28 SEN. TOOLE asked if there has been an analysis of how or if this data is related to high energy prices. Mr. Johnson said the LFD has received tax return data for 2003 and has historical data prior to 2003. Mr. Johnson said that 2004 data will not be available until December and January, but based on the 2003 data, the energy sector is influencing corporate tax collections.

00:34:25 SEN. GILLAN said the change in corporate profits has been very volatile and asked if that is due to a pattern or cycle. Mr. Johnson said that corporation tax collection is very volatile and is susceptible to economic activity, both at the state and national level. He said audit collections is another factor that contributes to the volatility. Years with large audit collections give the appearance that collections have increased. This can be followed by a year that does not have the same level of audit collections, which causes a drop in collections. Another factor can be unusual events, such as the sale of Montana Power Company, which resulted in high tax collections.

00:38:21 Mr. Johnson continued his presentation and discussed individual income tax data and the impacts of SB 407 - page 4, Exhibit #1.

TAPE 1 - SIDE B

00:47:34 Mr. Johnson summarized Montana tax return income data - page 5, Exhibit #1.

00:52:42 REP. MCALPIN asked if the new base line takes into account the possibility of an aberration, such as 9-11. Mr. Johnson said that if the LFD cannot identify the basis for a change in tax collections or characterizes the change as a one-time event, it adjusts that in the trend line.

00:53:59 REP. LAKE asked why there was a delay in refunds. Mr. Johnson said the delayed refunds were due to the implementation of SB 407. He said that a major accounting firm had recommended to its clients that they not change their estimated tax payments, in order to avoid penalties.

00:55:31 SEN. TOOLE noted that wage and salary income increased by 5.8% and asked how much of the increase could be attributed to increased wages and/or new jobs. Mr. Johnson said he would get that information and noted that the oil and gas activity going on in eastern Montana has significantly impacted wages.

00:57:08 SEN. TOOLE asked if there is any data on how much additional revenue would have been collected, had SB 407 not been passed. Mr. Johnson said the OBPP used two models to calculate a difference of approximately $30 million.

00:57:53 SEN. GILLAN asked for the long term impacts of SB 407 on capital gains. Mr. Johnson said that the benefit of the 1% tax credit in SB 407 is substantial but that it would be difficult to project how it will react in conjunction with federal statute and the preferential tax treatment that is in place there.

00:59:16 REP. WAITSCHIES asked if the large increase in audit collections is expected to be ongoing and what the percentage change is from past years. Mr. Johnson said the LFD relies on the DOR to provide audit collection estimates and that the Department collected over $37 million in audit revenue in fiscal year 2005 for individual income tax and is estimating that it will collect $20 million in fiscal year 2006 and $25 million in fiscal year 2007.

01:00:51 SEN. ELLIOTT asked if the capital gains income data included both full year and part year residents. Mr. Johnson said the estimate includes full year residents only.

01:01:21 Mr. Johnson discussed oil and gas revenues - page 7, Exhibit #1.

01:09:29 REP. LAKE asked how Mr. Johnson estimated an oil price of $57 per barrel. Mr. Johnson said that price was determined by tax return data and Global Insights and that the price is adjusted to account for large production states, such as Texas. Mr. Johnson said it is a fair assumption, based on the information at this point in time, and that oil and gas prices will remain high.

01:13:15 SEN. ELLIOTT asked if there is a reliable method to compare Montana oil and gas production with Wyoming's production rates. Mr. Johnson said that there are four factors that must be considered: higher energy prices, new technology, the specific production activity of a particular field, and tax policy. He said it would be difficult for him to isolate each factor in order to attribute how much of the increased production is taking place due to that factor.

01:15:07 Mr. Johnson discussed property tax revenue estimates - page 9, Exhibit #1.

01:18:25 Mr. Johnson discussed residual impacts of oil and natural gas changes on the common school interest and income account - page 10, Exhibit #1.

01:19:35 Mr. Johnson referred to the one-page summary of the recommendations (House Joint Resolution 2 Plus Legislation Impacts - EXHIBIT #3) said the table shows all of the 35 revenue sources by type.

TAPE 2 - SIDE A

01:22:56 Mr. Johnson said the LFD is recommending that the revenue estimates be adjusted by $253 million above what was adopted in HJR 2 in the 2005 Legislative Session (EXHIBIT #3). Mr. Johnson said the LFD recommendation is to increase the common school interest and income account estimate by $18 million. Mr. Johnson referred the Committee to page 11 of Exhibit #1 and discussed the 2007 biennium general fund outlook without Governor's proposal. He pointed out that the projected balance, before a reserve, is $425 million.

01:29:01 Mr. Johnson discussed the 2007 biennium general fund outlook, with Governor's proposal - page 11, Exhibit #1, and said the projected balance would be $235 million, before a reserve.

01:30:33 Mr. Johnson discussed the 2009 biennium general fund outlook, with Governor's proposal - page 12, Exhibit #1. Mr. Johnson said he has reservations about projecting this far out because of the volatility of several income sources. He said, based on the information available today, the LFD projects a $320 million balance before a reserve account.

01:32:44 Mr. Johnson discussed the 2009 biennium general fund outlook structural balance, with Governor's proposal. He said it is important to note that the ending fund balance of $84 million dollars is significant because it is the amount available for funding everything else in the budget, such as the cost of an employee pay plan, any new proposals over above present law costs, or other issues such as property tax relief or funding for water adjudication.

01:36:17 Mr. Johnson said the last point he wished to stress was that, when putting into context the $84 million structural balance projected in 2009, one of the key factors that must be discussed is what is anticipated to happen to oil and gas production in Montana. Oil and gas production has a critical impact on state revenue. Mr. Johnson discussed the impact of oil and gas on each source of revenue in Montana.

01:40:44 SEN. GILLAN noted that there is $3.2 billion anticipated revenue for 2009 and asked how Mr. Johnson calculated his projection. Mr. Johnson said he based his calculation on data gathered since the adjournment of the 2005 Legislature. The LFD determined recommendations for fiscal years 2006 and 2007, took the four key components of income tax, corporation income tax, property tax, and oil and gas production tax, and specifically developed further forecasts out to 2008 and 2009. For other general fund sources, the budget growth projection was used to identify long-term trend growth to project other sources of income. SEN. GILLAN asked which revenues can be sustained and said she doubted that all of the revenue projections would be accurate that many years out. Mr. Johnson said his point is that there are sources of revenue that are very volatile and that they are the larger sources. He agreed that it is difficult to truly accurately predict that far out.

01:44:59 SEN. GILLAN asked if the Global Insights projections reflect higher interest rates. Mr. Johnson said that interest rates are projected to be relatively stable through 2008 and 2009.

01:46:56 SEN. KITZENBERG said he interprets the estimates to indicate that the Legislature will be unable to do any property tax relief and that there will be no additional funding for education. Mr. Johnson said that legislative staff only prepares the information and does not set policy. It is the Legislature that must decide the spending priorities for the State.

01:48:16 REP. COHENOUR said the federal government is responding to its deficit situation by making cuts in its social programs and asked if those cuts have been taken into consideration by the revenue estimates. Mr. Johnson said those cuts have not been included and that significant changes in federal funding will impact the state budget.

01:49:22 SEN. TOOLE referred to page 7 of Exhibit #1 and asked why oil and gas prices are forecast to drop, particularly oil. Mr. Johnson said the oil price forecast was taken from Global Insights data, as adjusted for Montana. He said the forecast for natural gas was based on the futures market prices. He said that two different sources of information were being used to derive the price for Montana. SEN. TOOLE asked if the projections for gas production were also provided by Global Insights. Mr. Johnson said that projection was prepared by the LFD and explained how he calculated his projections.

01:53:07 SEN. TOOLE asked, regarding oil production, if the Cedar Creek Anticline and all of the new technology on tertiary production had been factored into the numbers. Mr. Johnson said that new technology is one reason why production has remained steady.

01:54:18 SEN. BARKUS asked what the oil and gas revenues for 2009 were projected to be. Mr. Johnson said he would get specific numbers but that a decline is expected. The primary reason is that a significantly lower oil price was projected for 2008 and 2009 and production was reduced for that period also.

01:55:49 SEN. BARKUS said there seems to be no apparent answer why capital gains spiked in 2004 but that if it truly is a spike, there will be a significant decline in revenues. He asked if that has been factored in to the estimates. Mr. Johnson said that it had been factored in.

01:57:09 REP. WAITSCHIES, regarding the 2007 biennium additional revenues of $253 million (page 11, Exhibit #1), asked for an estimation of how much of that projected growth is directly or indirectly attributable to oil activity. Mr. Johnson said he predicted that oil activity would account for a significant portion of the growth, but that he had not done a specific analysis.

01:58:44 SEN. ELLIOTT asked for an explanation of how the capital gains credit applies to part year versus full year residents. **Dan Bucks, Director, Department of Revenue (DOR),** explained how capital gains are reported in accordance with Montana and federal law, saying that a nonresident or part-year resident reports their total income and then a calculation is made to determine what portion of their income is Montana source income. The ratio of Montana source income to the total income of the individual then determines the tax base of the part-year and nonresident in Montana.

02:02:24 SEN. ELLIOTT asked if the 1% tax credit will apply only on Montana source income attributable to capital gains. Director Bucks said he was not certain about the technical points of the law and how it treats nonresidents and part year residents and that he would contact a tax technician for the information.

TAPE 2 - SIDE B

02:03:49 SEN. ELLIOTT said he would like that information because it is important to know what the tax credit will cost Montana citizens. Director Bucks said he would get the information.

02:04:40 Mr. Johnson discussed the DOR audit information (EXHIBIT #4). His discussion included information on how much the Department collects for individual and corporate audit collections, the impact of the now defunct POINTS system, and noted that it is the Department's decision on how aggressively to pursue audit collections. He said this is a significant issue for the Committee to be aware of because the LFD relies on the Department for much of its information and can affect the LFD's capability to make accurate assumptions. He said this is an issue the Committee may wish to discuss with the Department.

02:10:55 REP. COHENOUR said legislators were told during the 2005 session that, due to new computer system and staffing levels, that compliance will be better, therefore audit collections will decrease and asked if is this is an accurate statement. Gene Walborn, Department of Revenue, said audits are very difficult to project because many are a one time occurrence but said the Department does expect audit collections to decrease for the reasons stated by REP. COHENOUR.

02:13:22 REP. WAITSCHIES asked, regarding individual income tax payer audits, how many were due to mistakes, noncompliance, or nonfilers. Mr. Walborn said the majority of individual income tax audits are associated with "office audits", which are smaller amounts and are usually attributable to misreporting or errors on 1099 information. He said corporate income tax audits account for much larger collections and those are usually conducted as a field audit. Mr. Walborn said he is confident that much more detailed information will be available with the new system.

02:15:27 Director Bucks returned the information requested by SEN. ELLIOTT. Director Bucks said that the capital gains tax of a part year or nonresident is determined by calculating the individual's entire return down to the level of the Montana tax as if all of the income were taxed in Montana. A Montana tax is calculated on the income, including income that Montana will not be taxing. Then, under the new capital gains credit, the individual will subtract 1% of their total capital gains, including Montana source and non Montana source capital gains, and in future years, 2%. That amount is the Montana tax before the adjustment is made for Montana source income, which takes the ratio of Montana source income to the total income and times that tax (the tax minus the credit that was determined). and is the final Montana tax amount owed. Director Bucks said the way Montana calculates the tax is proportionally linked to what people are earning outside the state, as well as in the state and that variations in both can affect the final tax amounts.

02:19:10 SEN. ELLIOTT said his understanding of the law is that a taxpayer can get the credit even though they have made no capital gain in the State of Montana. Director Bucks said yes, if the person has some form of income in Montana that is not capital gains income and all of their capital gains are non Montana source gains. SEN. ELLIOTT asked if there is anyway of determining if this will be a significant amount of money. Director Bucks said that since this is a new law, no returns will be filed until 2006; so there is no way to make that determination at this time. He said the Department would be able to do an analysis next year after data becomes available.

02:21:56 SEN. BARKUS said it appeared to him that Montana is taxing part-year residents for income they earned out of state. Director Bucks said that Montana law requires that a taxpayer calculate their income based on their total federal income and then a Montana tax is calculated from that figure. That is not the tax collected but is a tentative tax. A separate calculation is done to figure their Montana source income and non Montana source income. If a taxpayer has income from another state and earns no income in Montana, but is simply a part-year or nonresident, then their Montana source income is zero and is calculated as such. But if the taxpayer has a 10% income from Montana source income and 90% is non Montana source income, the 10% is multiplied by the tentative tax and that is the amount that is attributable to Montana. That is a common method used by other states.

02:25:18 Mr. Schenck provided additional detail on, when looking out to the 2009 biennium, what some of the other contingencies might be in terms of how to prioritize payments. He said that over $3 billion dollars in revenues are projected to be collected in the next biennium and that the LFD makes several assumptions about how the Legislature will spend it:

- that the Legislature will follow present law assumptions, as it has in the past, and accept the executive recommendations even though it is not legally bound to do so;
- that additional funding, over and above present law funding, will have to be prioritized; and
- that the Legislature will adopt the executive spending proposal for these funding sources also .

Mr. Schenck said that the Governor's funding proposal of $31 million, if carried into the 2009 biennium, would leave approximately $42 million available for other spending proposals, if the Legislature accepts the first two assumptions the LFD has made. Mr. Schenck said the LFD would be remiss if it didn't it alert the Committee of what it will be faced with in the next biennium. Mr. Schenck discussed several specific examples:

- the pension fund unfunded liability bail out;
- a 2009 employee pay plan;
- possible changes in federal funding in human services programs;
- water adjudication fees;
- the Medicare Part B, prescription drug program;

- Old Fund workers' compensation fund shortage;
- supplemental appropriations shortfall;
- other new initiatives;
- ongoing education funding needs;
- state building and deferred maintenance program; and
- District Court and public defender programs.

02:47:38 **David Ewer, Budget Director, Governor' Office,** presented a Special Session Report, prepared by the Governor's Office of Budget and Program Planning (EXHIBIT #5), which included projections for the 2008 and 2009 biennium and a brief overview of programmatic challenges that will be faced. He complimented the work done by the LFD staff on the revenue estimates and said there is little substantive difference between the OBPP's estimates and those of the LFD.

TAPE 3 - SIDE A

03:04:02 SEN. ELLIOTT asked for a motion to adopt the revenue estimate recommendations. SEN. TOOLE **moved** to adopt the LFD revenue estimates.

03:04:28 REP. LAKE expressed concern regarding oil and gas revenues and proposed dropping the projected prices on oil and gas revenues to $50 per barrel.

03:06:22 SEN. TOOLE's **motion** to adopt the revenue estimates passed on a unanimous voice vote. REP. LAKE **moved** to amend the the oil and gas price to $50 barrel. SEN. GILLAN asked Mr. Johnson to comment on impact.

03:07:12 Mr. Johnson said he would like to do a more detailed analysis if the motion passed, but a quick calculation is that there would be about a $20 million reduction in estimates for fiscal year 2006. SEN. GILLAN asked if there would be a reduction in royalty payments. Mr. Johnson said the calculation would be strictly for the reduction for oil production taxes and that there would be a corresponding reduction in the effect on the interest and income component.

03:08:26 SEN. TOOLE said he shares REP. LAKE's concern but said that it will be counter balanced by the production numbers, giving a cushion. SEN. TOOLE said he will resist the motion.

03:09:00 REP. COHENOUR said an additional factor to consider is that new production has 18 months of tax free status, so she agreed with SEN. TOOLE and said she would also resist the motion.

03:09:36 REP. WAITSCHIES asked Mr. Johnson if the 18 month tax holiday is built into the revenue estimate. hiatus is built into estimate. Mr. Johnson said the tax holiday was factored into the estimates.

03:10:35 REP. WAITSCHIES asked what effect this would have on royalties. Mr. Johnson said he could calculate how the state would be affected but that the impact on individual income tax can not be estimated. REP. WAITSCHIES said that with a multiplier effect, if there is a price fluctuation, it changes both the individual and corporation tax. He said if there is a drop, it is multiplied, and that he would rather be safe with a lower estimate. REP. WAITSCHIES supported the amendment.

03:11:56 SEN. ELLIOTT said it is a complex adjustment and asked how long it would take to make the calculations. Mr. Johnson said he could, within an hour, calculate the impact of the motion on oil production taxes and on common school interest and income. He said the effects on corporate income tax and on individual income tax could not be done.

03:13:06 REP. COHENOUR said if the two anomalies in capital gains are removed, the trend line flattens out, so the LFD is making assumptions regarding the growth of oil and gas production and price. The trend lines are not based on the anomalies seen this past year and so she is comfortable with the forecast and would not support the motion.

03:15:00 SEN. BARKUS said he would the support motion but added that, if the motion passes, he would like to see the revenue estimates for income taxes increased mainly due to a stronger agriculture economy.

03:16:12 REP. MORGAN said she will support motion because there are major federal funding cuts coming that will have a great impact. She said she would vote on the side of caution, in order to avoid making cuts to programs that benefit the neediest of the needy, as happened in the last session.

03:17:40 SEN. ELLIOTT asked what is total impact of the price reduction would be. Mr. Johnson said the total impact of the reduction would be approximately $20 million and the impact to the general fund would be in the range of $8-9 million.

03:18:26 SEN. ELLIOTT said he has been told that the single largest constraint to increased oil production in Montana is availability of workers and rigs. **Jerome Anderson, Encore Acquisition, Co.,** said that the lack of trained employees has had detrimental effect on the state's production capabilities, particularly in Richland County. SEN. ELLIOTT asked if this will change. Mr. Anderson said some rigs have come from North Dakota but trained employees are still in short supply.

03:20:31 SEN. BLACK asked Mr. Anderson about the projected prices of oil for future years and asked what experts in the field are predicting. Mr. Anderson said the five investment banking institutions that do the principal financing for the oil and gas industry in the United States are predicting that oil and gas prices will be as follows: 2006 - $44 per barrel, 2007 - $39 per barrel, 2008 - $36 per barrel, and beyond that, $33 per barrel. Mr. Anderson said that the price per barrel does not take into consideration that Montana prices are discounted further than that.

03:23:23 REP. LAKE restated his motion to reduce the projected oil price per barrel from $57 to $50 per barrel. He said Montana counties would be better served by a lower, more realistic number and that he would prefer to err on the side of undervaluing, rather than overvaluing.

03:24:48 REP. LAKE's **motion failed** on a 6-6 roll call vote, with SEN. GILLAN, SEN. KITZENBERG, SEN. TOOLE, REP. COHENOUR, REP. HINER, and REP. MCALPIN voting no (ATTACHMENT #4).

03:25:59 SEN. ELLIOTT said revenue estimates are adopted as presented. Mr. Martin said a sponsor is needed. It was decided by a coin toss that REP. LAKE will be the sponsor.

03:27:48 **Greg Petesch, Director, Legal Services, LSD,** presented Lee Heiman's review of the Department of Revenue's proposed rule change relating to Montana source income (EXHIBIT #6). Mr. Petesch also discussed the Department of Revenue's notice of hearing (EXHIBIT #7). Mr. Petesch said this rule is what the Montana Administrative Procedure Act (MAPA) refers as an interpretive rule, which can be adopted under express statutory authority and codifies the way the agency interprets the law.

03:30:22 REP. MORGAN asked Mr. Petesch if the Department can make these changes or if this issue would be more appropriately dealt with by the Legislature. Mr. Petesch said the Department has been given an extremely broad grant of authority under Title 15, chapter 30, MCA, and is not violating rules. If the Committee feels that the interpretation is not consistent with the policy that the Committee likes, it can pursue several different options.

03:31:48 SEN. ELLIOT asked what the Committee's options are. Mr. Petesch said the Committee could:

- object to the rule and state the basis for the objection;
- submit written comments to the DOR, which would have to respond either in writing or at the public hearing prior to adopting the rule and would have to accept or reject the comments and explain why it did so;
- request that the DOR defer action on the rule; or
- request an economic impact statement on the rule.

SEN. ELLIOTT asked if the Department can still adopt a rule if the Committee objects to it. Mr. Petesch said the Department can adopt the rule but in the event of a challenge to the rule, the burden shifts to the Department because the rule was presumed to not be consistent with legislative intent, based on your objection.

03:32:56 REP. LAKE said that since the 1031 code is a federal code, does Montana have the right to separate itself from the federal code? Mr. Petesch said the Legislature may adopt a different method of determining and taxing income than the federal government. He said it is his understanding of state tax law that certain portions of the individual income tax return are tied to the federal income tax system but not all provisions are.

03:34:27 REP. MCALPIN asked who would have to bear the cost of an economic impact statement. Mr. Petesch said the DOR would have to pay for the statement and read what the economic impact statement must consist of [2-4-405, MCA]. REP. MCALPIN asked if an economic impact statement would affect the timing of the administrative hearing. Mr. Petesch said no.

03:36:41 SEN. BARKUS asked how property is defined in Montana under this code. Mr. Mr. Petesch said for purposes of Title 15, chapter 30, MCA, it is not.

03:37:08 SEN. ELLIOTT asked Committee members to state their objections to the rule change and to identify any particular portion of the rule objected to. REP. LAKE objected to the portion dealing with 1031 exchanges.

03:38:18 REP. WAITSCHIES asked if this is a retroactive rule. **TAPE 3 - SIDE B** Mr. Petesch said the rule is not retroactive but simply codifies the Department's interpretation. He said the Department, in his opinion, could interpret the definition of Montana source income the way it is proposing even absent the rule. The purpose of the rule is to give people notice of what their interpretation is and to allow comment on that.

Mr. Petesch referenced his statement to SEN. BARKUS regarding the definition of property under Title 15, chapter 30, MCA, and said there is a definition of property [15-1-101, MCA] that applies to all of Title 15. Mr. Petesch read the definition: "property includes money, credits, bonds, stocks, franchises, and all other matters and things real, personal, and mixed; capable of private ownership".

03:40:58 REP. WAITSCHIES asked Director Bucks if this is rule, if adopted, will apply to past taxes paid. Director Bucks said the Montana source income law was adopted in 2001 and is applicable to tax years 2002 forward, The Department is not changing anything with this rule, it is just applying the law and giving due and fair notice to taxpayers before the Departments commences with enforcements. He said there is widespread misunderstanding of the Montana source income tax law as it applies to real estate transactions, 1031 exchanges, and installment sales. Director Bucks said the Department is open to considering a period of flexibility regarding waiver of penalties and offers of compromise while educating the public.

03:44:22 REP. LAKE asked Director Bucks to explain further. Director Bucks explained that the Department is trying to provide notice to taxpayers regarding the Montana source income tax law with respect to real estate transactions. The proposed rule simply informs taxpayers and tax advisors of how the law works and makes sure that nonresidents are taxed the same as Montana citizens. States that levy income taxes rely heavily on the source income principal of taxation. Without applying the source income principle, states would only be able to tax residents, leaving nonresidents and out-of-state companies earning income in this state without any tax liability to the state. That result would be unfair to the residents of Montana. He distributed copies of and discussed 15-30-101(18)(a)(ii), MCA, (EXHIBIT #8). He said SEN. BARKUS's question about residency is addressed in this subsection.

Director Bucks said the confusion with installment sales goes to the question of whether a1031 exchange involves a sale. It is Director Bucks opinion that it does involve a sale. He referred to the Montana Association of Realtor's buy/sell agreement (EXHIBIT #9). He pointed out the language in the agreement confirming that this is a sale of property in Montana (page 6, line 314, Exhibit #9). Director Bucks said this is consistent with federal law, which does not allow for an exemption from taxation, but for a deferral. The federal law explicitly prevents an exemption from occurring by prohibiting anyone one from exchanging property in the United States with property outside the borders of the United States for the purposes of securing a deferral. The clear intent of federal law is not to allow an exemption when the exchange flows outside the borders of the jurisdiction. Montana accomplishes the same result as the federal law by the Montana source income rule. Once the gain has occurred in Montana, it is always Montana source income. If the exchange goes outside the state and is deferred, the ultimate calculation of that gain will be governed by the calculation of federal net income. Montana follows the federal calculation of the gain. Montana recognizes a deferral but not an exemption. Opponents of this rule argue for a result that is contrary to federal law by saying that if an exchange goes outside the state, it should be exempt from taxation in Montana. That is not consistent with federal law and the proper application of Montana source income law. Gains realized in Montana on the sale of property, including in installment sales and 1031 exchanges are Montana source income.

04:06:12 REP. LAKE commented that this may not be a change in law but is a change in the historical interpretation of the law. He said this is a big change in people's thinking and that he would like to deal with it in the 2007 Legislature. He said one of his main concerns is the record keeping. He said the provision for 1031 exchanges has been in place since the 1930s. It was intended to maintain working capital in the economy and Montana benefits from this, and should not discontinue this.

04:12:42 Director Bucks said that the proposed rule has no effect on 1031 exchanges by Montana residents. The only practical impact is on nonresidents. With respect to nonresidents, if Montana source income is taxed on the gains on the sale of property, that income is also taxable in the state of residency on that person's income tax return and they get a credit for the Montana tax against their home state return.

04:16:03 SEN. BARKUS asked for explanation of an out-of-state 1031 exchange and gave an example of the sale of a Wyoming ranch to an oil company. The rancher realizes a huge capital gain and is a resident of Montana. He asked how the proposed rule would affect such an exchange. **TAPE 4 - SIDE A** Director Bucks said the gain in that instance is a Wyoming gain and that this rule would not affect that transaction. If the rancher becomes a resident of Montana and doesn't continue the deferral until death but cashes out, as a resident of Montana he must pay taxes on his income, regardless of where it is earned, and if it is taxed in another state, there is a credit granted for that. He said that this particular situation is not affected by the source income rule, but by the residency requirement. He became a resident of Montana and is subject to taxation on all of the income he receives while he is a resident of the state, on both tangible and intangible income.

04:20:30 SEN. BARKUS asked for discussion of incoming 1031 exchanges. Director Bucks said Montana would not attempt to pick up the incoming gains if for example, the Wyoming rancher chose to live in South Dakota but purchased and remotely operated a ranch in Montana. If that Montana ranch subsequently had a capital gain, that is potentially taxable in Montana as Montana source income but Montana would not be picking up the prior gain from Wyoming that was rolled over into that because that is not Montana source income. It was not attributable to the sale of property in this state.

04:21:32 REP. WAITSCHIES asked if the rancher moved to Montana for two years and then moved out of state and is no longer a resident. It becomes problematic to attribute how much of the gain, without him selling it, when he moves out of state, is attributable to Montana. He said he knows of several real situations similar to this scenario and that it appears to him that he could attribute any amount of the gain he wished to where ever he liked. Director Bucks said in that situation, if the rancher moves out of state but maintains ownership of a ranch in Montana, there is no sale of the Montana ranch and so there is no Montana source income. REP. WAITSCHIES said the rancher sells the ranch after he has lived in California for two years. Director Bucks said if the rancher was a nonresident at the time of the sale, the gain would be Montana source income and would be calculated on the appreciation of the property in Montana. Director Bucks said there is a calculation rule to determine the gain attributable to the ranch in Montana. If it was a final sale, the gain would be realized at that point and recognized for tax purposes for federal and state purposes. If the rancher rolled the gain over into a California property and was a California resident, it would be a different matter. The calculation is not on the two years that the rancher is a resident of Montana but rather between the point of original acquisition of the ranch and the point of sale of the ranch.

04:25:23 REP. WAITSCHIES asked for an explanation of how an increase in value is determined in a 1031 exchange. **Brenda Gilmore, Attorney, DOR,** said that when a person engages in like-kind exchange, an 8824 federal form is filed.

That form shows the sale price, the amount realized, the basis in the existing property, and a calculation of how the basis in replacement property was determined. In the example being discussed, the Wyoming ranch was exchanged for a Montana property. The 8824 form would tell how much gain was realized on the Wyoming property, what the basis is in the Montana ranch, the extent to which the basis in the Montana ranch exceeded the gain when the Montana ranch was sold did not exceed the Wyoming gain - we would not attempt to tax Wyoming gain - would equal the amount of gain on the Montana ranch that would be Montana source income. Ms. Gilmore said until there is a sale, there is no triggering event. A gain is realized when a person gives up title to property and receives something of value in return. In like-kind exchanges, that realized gain is not recognized, it is deferred. There may be a triggering event that causes that gain to be recognized. It is only when that gain is recognized that it is subject to tax as Montana source income.

04:28:56 REP. WAITSCHIES said the question is how much to attribute to Wyoming gain and what the basis is for the Montana gain. Ms. Gilmore said all the gain shown as realized on the Wyoming form 8824 would not be Montana source income. REP. WAITSCHIES said the seller can manipulate the numbers on the 8824 form. Ms. Gilmore said the Department assumes that the fair market value would be reported on the form.

04:30:13 Director Bucks commented that a true 1031 exchange with no money exchange is an issue. The majority of exchanges occurring are third party exchanges with sales and have accounting rules and accounting practices applied to them.

04:31:22 REP. COHENOUR said she is confident the law is as it should be, as determined by the 2001 Legislative session, and the rule should be noticed. REP. COHENOUR said the 8824 form is filed every time an exchange occurs. It is filed with the federal government, including the terms of sale. The 8824 forms are filed for each transaction. If the person decides to stop doing this, that triggers the allocation to each of those sales. Based on the 8824 forms that were filed, Montana would know there is a recognizable gain. The federal government wants this tracked in order to know where to attribute the taxes and each state realizes whatever gain there was from the tangible property that was actually in that state. Director Bucks said in the chain discussed by REP. COHENOUR, the IRS is tracking the deferrals for its own purposes and making sure that tax is correct on the accumulated gain. It is important to understand that the IRS is not tracking the states this is occurring in. That is controlled by state law and in this instance, Montana has determined that the gain on the sale of Montana property is assignable to this state, if there is a taxable event at the end of the string of all of these exchanges. REP. COHENOUR said Montana should treat everyone the same and that when there is a gain at any point, there must be a way to recover gains which originated in Montana. This is an equity issue and taxpayer equity is the intent of the law.

04:38:07 SEN. TOOLE said the language in statute is very clear and that the Department has the authority to do this and is making an effort to communicate with the public.

04:39:59 REP. LAKE asked if an individual from another state moves to Montana with a 1031property and has the tax event, does the Montana gain start from the basis of what he had in the state that he left. Director Bucks said if he is a resident of Montana he is taxable, not only on his Montana source income, but his out of state source income as well. If the state that he came from taxed the income also, Montana would give him a tax credit.

PUBLIC COMMENT

04:42:58 **Mike Green, State Tax Specialist, Montana Taxpayers Association (MTA),** said the MTA said he believes Director Bucks is genuine in his attempt to tax only Montana source gains but the rule before the Committee's consideration does not do that. It is the MTA's position that the rule is an expansion of Montana law and sets Montana apart from other states. Mr. Green explained the rationale for the MTA position (EXHIBIT #10).

04:46:02 SEN. ELLIOT asked if this rule affects only Montana taxpayers, as opposed to out of state taxpayers . Mr. Green said that would be difficult to answer and but that if probably doesn't affect the tax burden imposed on a Montana resident under the existing tax code. Mr. Green pointed out that the Society of CPA's agrees with this assessment. Director Bucks and this Committee have raised important policy issues that should be addressed because deferred gain arises in other situations beyond 1031 exchanges. He said the DOR rule is not the solution and the solution requires a much more complex fix than is being proposed.

04:49:06 SEN. ELLIOTT asked how this rule differs from law. Mr. Green said that currently, if a nonresident exchanges property out of Montana, that gain is never taxed and has never been taxed. He used an example of a Montana rancher who exchanges his ranch for a Wyoming ranch and defers that gain through a 1031 exchange. Under historical Montana law, that gain is never taxed by Montana. On the flip side, if a Wyoming resident exchanges his Wyoming property for Montana property and sells that property, the entire gain, whether appreciated in Wyoming or Montana, is taxable by Montana. Montana historically has taxed two sources of income: all of the income of its residents and all of the income of nonresidents from the sale or from the income of property located in the state. This rule expands Montana's tax code and adds a new source of revenue and is taxing income from the sale of property located outside of Montana.

04:50:28 SEN. TOOLE asked if Mr. Green believed the definition of source income in the statute is bad public policy and if he believes that people in the past, if they had a gain on property in Montana don't have tax liability for that property. Mr. Green said he has not discussed that issue with the client but as a taxpayer, he does not have a problem with the policy. It makes sense to tax the appreciation on real property in Montana. He said his point is that is not what has been done historically and is not what the majority of states do. This would set Montana apart, not only from prior law but from the laws of most of the states around us. If Montana is going to implement this policy, there must be rules to identify what Montana source gain is and what gain attributable to sale in Montana is.

04:54:02 SEN. ELLIOTT read 15-30-101(18)(a)(ii), MCA. He read 42.2.302(a) Definitions (EXHIBIT #7). He asked Mr. Green what he sees as the problem. Mr. Green said the problem is that the term "gain" is not defined in the Montana Code Annotated. SEN. ELLIOTT said the term "gain" was not defined in the law that he just read, which was supported by the MTA in 2001. Mr. Green said it was supported with the background that "gain" is defined by the Internal Revenue Code. He said the problem is applying the Montana sourcing rules, which has to have a different definition than federal income because appreciation can occur in different places and the federal code has no mechanism for accounting for those appreciations in different locations. SEN. ELLIOTT asked if the federal definition of "gain" was acceptable to the MTA. Mr. Green said yes. SEN. ELLIOTT said it hasn't changed and asked why the MTA disagrees with the definition now. Mr. Green said the MTA has no concerns with the statute but believes that the rule changes the definition. SEN. ELLIOTT asked why. Mr. Green said the rule brings gain in that was not previously recognized for Montana purposes. SEN. ELLIOTT asked why it was not. Mr. Green said because it was deferred and not recognized on the Montana income tax return under section 1031 of the Internal Revenue Code. Historically, Montana has not taxed gain deferred out of state.

04:56:4 SEN. ELLIOTT asked Ms. Gilmore to explain how deferred gain is not taxable in Montana. Ms. Gilmore said previous to 2001,when the Montana source income rule was adopted, she could not tell whether or not the state ever asserted tax over a nonresident for gain that was deferred through a substitute basis mechanism in another state. The language completely changed in 2001. Montana source income language was adopted, and the statute that governs the taxation of nonresidents, under 15-30-105, MCA, incorporated the concept of Montana source income. The rule of taxation for nonresidents says a nonresident completes their tax return just like a resident does and their ultimate tax liability is determined by multiplying the ratio of the Montana source income to worldwide income. Director Bucks said the law is being clearly and properly applied. He said the public rules process is intended to give due notice. He said this law has been misunderstood in the past, that the Department had not enforced the law in past years, and that the Department is now trying to clarify and enforce the law.

05:01:56 **Eric Burke, MEA-MFT,** said the MEA-MFT believes this is sound tax policy for Montana, that it is an appropriate directive from DOR and that the MEA-MFT is in support of the rule.

05:02:57 **Glenn Oppel, Montana Association of Realtors,** agreed with Mr. Green's statements and said this is a change in policy and would have a significant impact on economic growth in Montana. Mr. Oppel urged the Committee to object to the rule and to postpone implementation.

05:03:40 **Bruce Spencer, Auto Dealer's Association,** said his clients use 1031 exchanges, that implementing the rule would prohibit economic growth, and that he believe this is a change in policy that should be addressed legislatively.

COMMITTEE DISCUSSION

05:04:45 REP. MORGAN said, based on Mr. Green's testimony, her position is that the Committee should object to the rule because it is very complex and should be addressed by the full Legislature.

05:05:26 SEN. GILLAN asked if the Committee would support an economic impact study to provide additional data. REP. WAITSCHIES supported the suggestion, saying the study would help answer the many questions raised. Mr. Petesch said the economic impact study would not impact the hearing date.

05:06:59 In response to questions by SEN. BARKUS regarding the effect of an economic impact statement on the rule hearing, Mr. Petesch said if the Committee asks the Department to prepare an economic impact statement, the statement must be submitted to the Committee within three months of the date of the request. At that time, the Committee will determine whether the statement is sufficient. The only condition that the Department has to operate under is that it has to adopt the rule or start over in the rule making process, unless the final notice of adoption of the rule is filed within six months of the date of the original notice. An objection to the rule can delay, until the end of the six month period, the date for adoption of the rule.

05:10:08 SEN. GILLAN **moved** to ask for economic impact statement to clarify questions raised in the discussion.

05:11:25 REP. LAKE asked to add to the motion a request that the department not enact the rules until the impact statement is received. REP. COHENOUR asked if this would affect the timing of the rule going into effect. Mr. Petesch said the economic impact statement must be presented before implementation of the rule could occur.

05:12:47 REP. WAITSCHIES asked if the DOR is willing to wait on the hearing until the economic impact statement is completed. Director Bucks said the hearing process is an attempt to gather information from the public and that he is unclear as to the purpose of waiting for the hearing.

05:13:55 SEN. ELLIOTT said that if the Committee requests an economic impact study, and the Department holds the hearing on the posted date, the rule cannot go into effect until this Committee has reviewed the economic impact statement. He asked what would happen if the Committee rejected the economic impact statement. Mr. Petesch said it would be an objection to the economic impact statement, not the rule and the Committee would have the opportunity to comment on the sufficiency of the economic statement and could request the Department to correct the statement, but the final adoption of rule is not subject to a court challenge on basis of economic impact statement. SEN. ELLIOTT asked if the Committee could object to the rule at the hearing. Mr. Petesch said the Committee could object to the rule any time, prior to final adoption.

05:15:38 SEN. TOOLE commented that this is a clearly worded statute and it is the Department's job to implement it. This statute was adopted by the Legislature and if there was some kind of unintended consequence, it can be dealt with through the objection process and let the Department get on with implementation of the rule.

05:21:57 SEN. ELLIOTT stated that he could not, in his interpretation, see any difference between the proposed rule and enacted law. He said he will not vote to object to the rule or for an economic impact statement.

05:17:36 SEN. BARKUS **moved a substitute motion** to postpone the rule hearing until 30 days after the receipt of an economic impact statement. SEN. GILLAN objected to postponing the hearing.

05:25:13 SEN. BARKUS's **substitute motion to request postponement of the hearing and to request an economic impact statement failed on a 5 - 7 roll call vote**, with SEN. ELLIOTT, SEN. GILLAN, SEN. KITZENBERG, SEN. TOOLE, REP. COHENOUR, REP. HINER, and REP. MCALPIN voting no (ATTACHMENT #5).

05:26:18 SEN. GILLAN's **motion to request an economic impact statement failed on a 6 - 6 roll call vote**, with SEN. ELLIOTT, SEN. KITZENBERG, SEN. TOOLE, REP. COHENOUR, REP. HINER, and REP. MCALPIN voting no (ATTACHMENT #6) .

ADJOURNMENT

05:27:20 With no further business before the Committee, SEN. ELLIOTT adjourned the meeting at 1:30. The next meeting will be held at 7:30 a.m. on Friday, December 16, 2005.

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