

TESTIMONY BEFORE THE INTERIM FINANCE & TAXATION COMMITTEE

July 2, 2008

Property Tax Relief 2007 Senate Bill No. 2032 Issues Encountered

INTRODUCTION

The implementation and administration of SB 2032 (codified at N.D.C.C. §§ 57-38-01.29 and 57-38-01.30) presented the Tax Department with many opportunities and challenges. The Department's mission under SB 2032 was to deliver property tax relief in the form of an income tax credit and to develop a system of providing the same relief to individuals who are not required to file income tax returns. In meeting the challenges posed by SB 2032, we believe we developed some innovative solutions. We believe the success of the program is measured by the following statistics:

Property Tax Relief - Income Tax Credit						
Credits Processed						
Credit Type	Residential/Ag		Commercial		Total	
	\$	#	\$	#	\$	#
<i>Individual Income Tax Return- Form ND-1</i>	\$34,429,674	139,301	\$2,731,977	11,752	\$37,161,651	151,053
<i>Individual Income Tax Return- Form ND-2</i>	\$93,556	452	\$12,182	71	\$105,738	523
<i>Form ND-3</i>	\$348,914	2,666			\$348,914	2,666
<i>Corp Income Tax Return- Form 40</i>			\$120,977	391	\$120,977	391
Total	\$34,872,144	142,419	\$2,865,136	12,214	\$37,737,280	154,633
Certificates Issued	Residential/Ag		Commercial		Total	
	\$	#	\$	#	\$	#
<i>Individual Income Tax Return- Form ND-1</i>	\$4,962,900	24,607			\$4,962,900	24,607
<i>Individual Income Tax Return- Form ND-2</i>	\$70,478	335			\$70,478	335
<i>Form ND-3</i>	\$348,288	2,643			\$348,288	2,643
Total	\$5,381,666	27,585			\$5,381,666	27,585
# Returns that reached the Maximum Property Tax Credit						
	Residential/Ag		Commercial		Total	
<i>Individual Income Tax Return- Form ND-1</i>	4,145		1,044		5,189	
<i>Individual Income Tax Return- Form ND-2</i>	7		1		8	
<i>Form ND-3</i>	3				3	
<i>Corp Income Tax Return- Form 40</i>			54		54	
Total	4,155		1,099		5,254	

Notwithstanding these successes, we do not believe that the income tax is the proper vehicle to provide property tax relief, particularly in the manner provided by SB 2032.

The rest of this document addresses the problems we encountered during the administration of the property tax relief program. Some of these issues can be easily resolved through legislation; however, the vast majority of these issues cannot be solved due to the inherent differences between property tax and income tax concepts and the numerous ways in which title to property can be held.

ELIGIBILITY/OWNERSHIP ISSUES

1. Trusts, Estates, and Other Business Entities Owning Residential or Agricultural Property.

SB 2032 provided relief to “individuals with a primary residence in North Dakota.” Because of this limitation and with certain exceptions, residential and agricultural property held by a trust, estate or an entity other than an individual with a primary residence in North Dakota, is not eligible for relief. The homestead income tax credit did not provide the statutory language that is required before owners/members of a pass-through entity can claim a credit earned by the entity.

For example, partnerships, S corporations, or limited liability companies owning agricultural property cannot receive a credit. Because there are many farm corporations and farming partnerships, this omission in the statutory language resulted in many in the farming industry not receiving property tax relief for agricultural property.

Another example involves an individual whose residence was owned by a trust. The person residing in the home was not the trust grantor, and therefore was not eligible for the property tax credit, even though the individual’s primary residence was in North Dakota.

There are two exceptions to the rule that trusts, estates and other business entities do not qualify for the credit. The two exceptions are for grantor trusts and single-member LLCs. The reason for these two exceptions is that for federal income tax purposes, the grantor

trust and the limited liability company is a disregarded entity. Thus, the trust grantor and the single member of the LLC must report all income and expenses of those entities on their individual income tax returns.

2. Nonresidents Owning Residential or Agricultural Property.

Individuals whose primary residence is outside North Dakota are not eligible for the relief even though they own residential or agricultural property in this state, pay property taxes in this state and pay income taxes in this state. We received many negative comments about this particular aspect of the program, particularly from previous residents who may have moved out of state for health or family reasons, yet wanted to retain their family's homestead. On the other hand, a nonresident is entitled to claim the credit for commercial property the nonresident may own. This different treatment creates an internal inconsistency in the program which may need to be addressed if the program is to be continued.

3. Individuals Who Do Not Have A Filing Requirement and Own Commercial Property.

For those individuals who do not have a North Dakota income tax filing requirement but pay property taxes, SB 2032 required the Tax Department to develop a certificate that the individual homeowner could take to their County Treasurer's office for redemption. However, that certificate is allowed only for residential or agricultural property taxes. The certificate option was not made available for commercial property owners.

One example of how this (and the use of property tax classifications) negatively impacted taxpayers involved an individual whose home was on a large lot. For property tax purposes, this lot was divided into two parcels. The actual residential structure was located on only one parcel. The other parcel, which the taxpayer considered part of their residence, was located on the other parcel. But because the one parcel did not have a residential structure on it, it was classified and assessed as commercial property. The

owner did not receive any credit for this parcel because they did not have an income tax filing requirement.

4. Property Held by Joint Owners

Generally, property tax statements are mailed to only one of the co-owners of jointly held property. This results in one or more owners not having the information they need to claim the credit on their share of the property taxes.

However, during our processing season, we found that there are some counties that will divide the total property tax assessment based on the number of record owners and will send a statement to each owner assessing the pro rata share of the total taxes due.

Because of the different practices from county to county, we are unsure of how to instruct taxpayers for the next filing season on how to calculate the credit to account for these property tax statement differences.

Even with our best efforts at trying to explain how the credit should be claimed on jointly owned property, many of taxpayers have erroneously claimed more (or less) than their share of the credit.

We also saw instances where the correct calculation of the credit created unfair results. One such situation involved an individual who managed an agricultural partnership for which he and his sisters were partners. The sisters performed no activity on behalf of the partnership. The brother was thrilled to learn that they qualified for the credit because the property was titled in their individual names, but then was disheartened to learn that as a nonresident, he did not qualify. He then thought his sisters should be able to split the credit 50/50, but because the statute required the credit be in proportion to the actual ownership interest, the sisters were only able to get 33.3% each. He was not one of our satisfied taxpayers.

5. Different Caps for Married Filing Joint Filers v. Single Filers

One issue raised by single individuals is the inequity of the \$500 cap. For example, you have two identically classified properties with the same amount of tax assessed. One property is owned by a married couple and the other owned by a single individual. The property tax relief afforded the single individual is half of the amount available to the married couple, even though the property tax burden was identical. If the property tax relief program is continued beyond the two year program, this inequity may also need to be reviewed by the legislature.

PROPERTY TAX CLASSIFICATION ISSUES

One of the challenges administering this program was basing the credit on the three classes of property – residential, agricultural, and commercial. Having two different credits based on different property classifications complicated the application of the law because it required taxpayers to know how their property is classified for property tax purposes.

In general, the classification of property is not a relevant consideration in the field of federal and state income taxation. What is relevant is how the property is used or held by the taxpayer, i.e. is the property used for business purposes. Many income taxpayers do not understand some of the rules for classifying property, such as:

- Property is classified as residential if used as a dwelling and contains no more than three separate family units. If there are more than three separate family units, the property is classified as commercial.
- Commercial property includes all property that does not fall under another classification, including vacant lots in a residential-zoned area.
- If property is used for more than one purpose, e.g., a house in which you live and operate a beauty shop, the portion of the house used as a beauty shop will be classified as commercial and the rest of the house as residential.

- Property zoning does not impact how property is classified for property tax purposes. Property that is zoned residential may be assessed as commercial property if a residential structure has not been built.

One example of how using property classification caused confusion involves a retired native North Dakotan who moved to Arizona, but still owns rental housing in the state. On the duplex he owns, he did not receive any property tax relief because the duplex is assessed as residential property. On his 4-plex apartment unit, which was next door to the duplex, he received relief because this property is classified as commercial property for property tax purposes.

Consequently, we suggest that if the current property tax relief program is to be continued, we recommend that the program “decouple” from the use of property tax classifications to determine credit eligibility.

SALE & LEASE ISSUES

1. Property Sales or Exchanges

The question of who is eligible for the property tax credit when there was a sale or exchange of property during the property tax year is an equity issue that cannot easily be resolved legislatively. This is because of the various contractual arrangements entered into by buyers and sellers of real property. Many times, the parties will allocate the property taxes between the buyer and seller. In some arrangements, payments will be made directly to the county by the seller. Some arrangements do not require this and the tax allocation just affects the purchase price.

The solution arrived at by the Tax Department was that the individual who actually owned the property on January 1, 2007 and January 1, 2008 (which are the 2006 and 2007 property tax due dates) is the person eligible for the income tax credit. We reasoned that in most circumstances the seller would still be able to claim a credit, even though it is on the new home or property. This was the simplest and least burdensome

solution, although we acknowledge that in some circumstances it may not be the most equitable.

An example of a situation in which there appears to be no easy answer involved a family that bought a home in January 2008. In order to record the deed to the property, this family had to pay the 2003, 2004, 2005, 2006, and 2007 delinquent property taxes. This family did not receive a credit on their 2007 return, nor will they be eligible for a credit on their 2008 return because they did not own the property on January 1, 2008.

We have attempted to arrive at a possible solution – one that doesn't involve the Tax Department requiring copies of sales contracts and applying different rules for different situations depending on those contractual arrangements. We do not believe this can be easily remedied without imposing substantial and onerous requirements on property owners.

2. Other Interests in Property

The one area that caused much discussion within the Department was how to address the many different types of interests that individuals may have in real property and how to apply the plain language of the statute, which refers to "property owned by the taxpayer." The difficulty is that while the ultimate responsibility for payment of property taxes resides with the fee owner, this obligation is many times imposed on the tenant or individual(s) occupying or using the real property.

Examples of the following types of commonly encountered situations in which the tenant/occupant pays the property taxes are:

- Life estates with remainder interests;
- Agricultural land leases;
- "99-year" or long term leases;
- "Triple-net" leases;
- Contract for deeds; and

- Trust arrangements.

Because of the variety of ways that individuals transfer full or limited possessory interests in property, it would be difficult to draft legislation to encompass all possible situations.

ADMINISTRATION ISSUES

1. Verification Issues

SB 2032 placed two separate caps on the homestead income tax credit and on the commercial property tax credit. If the cap for the residential and agricultural tax credit is met, the Tax Department is charged with reducing the credit percentage from 10% based on the statutory formula. If the commercial property tax cap is met, the Tax Department will reduce the per taxpayer cap of \$1000/ \$500. The amount of the reduction is also based on a formula provided for by statute. The determination of whether either cap has been met will be certified by the Tax Commissioner on November 15, 2008.

This short time frame for determining how the credit will be calculated for the 2008 tax year was one of our major concerns when we were developing this program. The Tax Department wanted to ensure that the proper amount of credits were being claimed and to have the ability to independently verify this at the time the return was filed. We believe this was the only way we would be able to have an accurate accounting of credits claimed by the November 15, 2008 certification date.

The implementation team discussed many options and determined at that time that the use of parcel numbers was the best method. Use of parcel numbers would also help administer the credit for property held by more than one individual. Using parcel numbers also eliminated the need for taxpayers to file a copy of the property tax statements with the return, which is especially important for those using electronic, paperless methods of filing returns with our office.

The Tax Department contacted the counties and their software vendors to obtain the needed data. The counties agreed to partner with us and graciously worked with our IT staff. As a result, we were able to obtain all the property tax information from all 53 counties and were able to administer more efficiently the property tax relief program.

Notwithstanding the Department's education efforts and our partnership with the Counties, using the wrong information such as street address and incorrectly recording the parcel number were the most common filing errors made by taxpayers and tax practitioners when preparing the Schedule PT and the ND-3. The use of parcel numbers was also one of the more common complaints we received. Many taxpayers had 50 or more parcels to enter into their Schedule PT or ND-3 before they reached the per taxpayer cap.

However, at this time, we have yet to develop an alternative method of verification that does not require filing paper copies of the property tax statements. And even then, property tax statements are only a partial solution because, as discussed earlier, these statements do not contain all the information a taxpayer may need.

2. Software Vendor Support

Another concern we had when implementing SB 2032 was whether software vendors would support it, particularly because over 60% of returns are electronically filed. Our concern was well-founded as many of the software companies did not support the Schedule PT or the ND-3. In some cases, if the company did support these schedules, they supported it poorly.

For instance, one well known software vendor created its program in such a way that taxpayers were missing the link to the property tax relief schedules. In fact, this happened to one of our staff. The result is that many taxpayers did not claim the credit on their original return. In order to remedy this situation for those taxpayers, the Department created an alternative method of filing the correct schedules so that amended

returns would not have to be filed. This has created additional work for taxpayers and tax practitioners, as well as Tax Department staff.

3. Property Tax Relief Certificates

The property tax relief certificate was an innovative solution for bringing relief to those individuals who are able to remain in their homes, but do not have sufficient income to have an income tax filing requirement. Under this aspect of the program, the Tax Department issues a certificate to the individual for the amount of their credit. The certificate also instructed the individual to take the certificate to the county treasurer to be redeemed.

Our biggest concern was, and still is, making sure we reach all of the people the legislature intended to receive relief through the certificate program. For the most part, these individuals are not “in our system” which prevented us from contacting them by mail. We contacted many organizations that provide services to the elderly and lower income individuals, such as RSVP, the local Senior Centers, the North Dakota Pharmacy Association, and even the Department of Health and Human Services. As you can see by the statistics for the ND-3, we reached approximately 2,600 individuals. We believe there are more people that are eligible for property tax relief, and we will be doing additional outreach to this demographic later this summer.

As well as providing a method of getting relief to the lower income home owners, SB 2032 was written in such a manner as to give all taxpayers an election to obtain the certificate or to carryforward the unused credit. As you can see by the statistics, many certificates were provided to those who did have a North Dakota income tax filing requirement. The combination of an income tax credit with the certificate option was the source of much confusion among many tax practitioners (who are used to carryforward provisions) and taxpayers.

For example:

- Taxpayers were sending the certificates to the Tax Department for redemption.
- Taxpayers expected or thought they would be receiving a check for property tax relief.
- Counties incurred increased labor and administrative costs for redeeming certificates and for mailing payments to the taxpayers.

CONCLUSION

While we believe the program was successful in that almost \$40 million dollars of property tax relief was delivered to the citizens of North Dakota and we expect more relief to be provided to taxpayers this fall when we start receiving extension returns. Providing broad-based property tax relief was by no means an easy task for tax practitioners, taxpayers, the counties or for Tax Department staff. The examples provided to you today are a small sample of the numerous situations addressed by Tax Department staff during this past filing season.

Because of the inherent differences between income taxes and property taxes, we have concluded that without substantial changes to the program, the income tax is not the best delivery system for property tax relief. However, if it is determined that the program should continue, the Tax Department welcomes the opportunity to work with the Legislature to address these problems.

