



## Revenue and Transportation Interim Committee

### 62nd Montana Legislature

#### SENATE MEMBERS

CHRISTINE KAUFMANN--Vice Chair  
RON ERICKSON  
JEFF ESSMANN  
KIM GILLAN  
JIM PETERSON  
BRUCE TUTVEDT

#### HOUSE MEMBERS

ROY HOLLANDSWORTH--Chair  
DICK BARRETT  
CYDNIE (CARLIE) BOLAND  
BRIAN HOVEN  
SUE MALEK  
MIKE MILLER

#### COMMITTEE STAFF

JEFF MARTIN, Lead Staff  
MEGAN MOORE, Research Analyst  
JARET COLES, Staff Attorney  
FONG HOM, Secretary

April 26, 2012

TO: Revenue and Transportation Interim Committee

FROM: Jeff Martin, Legislative Research Analyst

SUBJECT: Alternative Methods of Taxing Individual Income

One of the reasons contained in House Joint Resolution No. 13 (2011 Session) for conducting the study of simplifying the taxation of individual income was that:

the enactment of deductions, exclusions, exemptions, credits, and other special tax provisions may not achieve their intended purpose and may increase the complexity of complying with the state's individual income tax laws and increase the costs of administering and enforcing the state's individual income tax laws.

The resolution directs the appropriate interim committee (Revenue and Transportation Interim Committee) to evaluate the advantages and disadvantages of simplifying the state's individual income tax structure according to specified criteria:

- conformity with federal income tax laws;
- the individual income tax base;
- the reduction or elimination of deductions, exclusions, exemptions, credits, and other special tax provisions;
- revising Montana's individual income tax rate structure;
- the filing provisions for married taxpayers.

The combination of a large number of adjustments to the individual income tax base and allowing married taxpayers to file separately has been cited as contributing to the complexity of the state's individual income tax structure.

This memo discusses some alternative approaches to taxing individual income in Montana that may help simplify the state's income tax system. They are offered as discussion items to help the Committee decide which options, if any, to consider. They may include the alternatives described in this memo or other options.

### **Taxing Individual Income Under Variations of Existing System**

Jaret Coles, Committee staff attorney, has compiled for the April 26 meeting data on additions to and subtractions from federal adjusted gross income, itemized deductions, and tax credits and a synopsis of each provision. One approach for simplifying the state's individual income tax laws would be to review the state-specific adjustments to taxing individual income and assess whether the intended purpose of the adjustment outweighs the actual or perceived additional complexity. Unless a large number of deviations are eliminated, this approach may reduce the complexity of the income tax structure only incrementally.

Another approach would be to require married taxpayers to file their state tax returns using the same filing status as on their federal return for the tax year. Allowing married taxpayers to file separately on the same form typically results in a lower tax burden than if they filed jointly. However, the complexity of the system owing to the high number of deviations from federal income tax law may be made worse by allowing married taxpayers to file separately. In addition, it is not always evident whether filing separately is to the advantage of the taxpayers.

In lieu of requiring married taxpayers to file a state tax return using the same filing status as the federal return, separate rate tables could be formulated so that the tax would be the same whether they filed jointly or separately. Different tax rate tables could be developed for single taxpayers, married taxpayers filing jointly, married taxpayers filing separately, head of household taxpayers, and surviving spouse taxpayers.

### **Revising the Income Tax System**

During the course of the study of simplifying Montana's tax laws, the Committee has been presented with information on states that tax individual income based on federal taxable income, and the Committee has discussed, at least in passing, taxing individual income based on adjusted gross income less personal exemption amounts and standard deduction amounts.

The remainder of this memo describes proposals considered by the Montana Legislature to revise individual income taxation based on these two concepts.

### **Individual Income Tax Based on Federal Taxable Income**

At the February 16, 2012, Committee meeting, Jaret Coles, staff attorney, described the tax return and instructions for Colorado, which taxes individual income using federal taxable income as a starting point.

There are eight states that use federal taxable income as the starting point to determine state taxable income. Six states (Idaho, Minnesota, North Carolina, Oregon, South Carolina, and Vermont) follow the Internal Revenue Code as of a specific date, and two (Colorado and North Dakota) follow the current Internal Revenue Code. By tying to a specific date, a state may have to specify additional adjustments if changes to federal tax law occur after the date.

The table below shows the tax rate structure for the seven states using federal taxable income as the starting point.

State	Tax Rate Range--%		Bracket	Income Brackets--\$		Personal Exemptions--\$		
	Low	High	Number	Lowest	Highest	Single	Married	Dependents
Colorado	4.63	--	1	Flat rate		3,700	7,400	3,700
Idaho	1.6	7.8	8	1,338	26,760	3,700	7,400	3,700
Minnesota	5.35	7.85	3	23,670	77,731	3,700	7,400	3,700
North Carolina	6.0	7.75	3	12,750	60,000	1,150	2,300	1,150
North Dakota	1.51	3.99	5	35,350	388,350	3,700	7,400	3,700
Oregon	5.0	9.9	4	2,000	125,000	183	366	183
South Carolina	0.0	7.0	6	2,800	14,000	3,700	7,400	3,700
Vermont	3.55	8.95	5	35,350	388,350	3,700	7,400	3,700

Source: Federation of Tax Administrators, January 2012

Only Colorado (one income tax bracket) and North Carolina do not adjust income tax brackets for inflation. All the states, except North Carolina and Oregon, use the inflation-adjusted federal personal exemption amounts. In Oregon, the personal exemption is a tax credit instead of a deduction. Oregon also allows a deduction of up to \$5,950 for federal income taxes.

For joint returns in Idaho and Oregon, taxes are twice the tax on half the married taxpayers' income. The income tax brackets reported for South Carolina apply to all filers. The income tax brackets reported for Minnesota, North Carolina, North Dakota, and Vermont are for single taxpayers. For married taxpayers filing jointly in each of these states, the range of income tax brackets is:

- Minnesota: \$34,590 to \$137,431
- North Carolina: \$21,250 to \$100,000
- North Dakota: \$59,100 to \$388,350
- Vermont: \$59,050 to \$388,350<sup>1</sup>

During the 1999-2000 legislative interim, the Revenue and Transportation Interim Committee (nee Revenue and Taxation Interim Committee) spent the latter months of the interim working

---

<sup>1</sup>Federation of Tax Administrators, State Income Taxes--updated January 1, 2012. Retrieved from the Internet at [http://www.taxadmin.org/fta/rate/tax\\_stru.html](http://www.taxadmin.org/fta/rate/tax_stru.html), April 9, 2012.

on a proposal to revise the state's income tax structure based on federal taxable income. The Committee requested legislation for introduction in 2001 to implement the proposal.

The legislation (Senate Bill No. 173) would have generally revised the income taxation of individuals, partnerships, and subchapter S corporations, including estates and trusts, by imposing the tax on a taxpayer's federal taxable income (with adjustments). The legislation would have eliminated most deductions from federal adjusted gross income, most state-specific itemized deductions in computing net income, all personal exemptions, and several income tax credits. The legislation would also have repealed the termination date of the tax credit for contributions to a qualified endowment.

Montana taxable income was defined as federal taxable income as adjusted. As such, federal personal exemptions and standard deduction amounts would have applied in determining Montana taxable income.

Under the proposed legislation, additions to federal taxable income would have included:

- interest on obligations of another state or political subdivision of another state; and
- a nonqualified withdrawal from a medical care savings account, family education savings account, or first-time home buyer savings account.

Subtractions from federal taxable income would have included items that are exempt from taxation by the states under federal law:

- interest from obligations of the federal government;
- railroad retirement benefits (Tier II);
- tribal source income.

Subtractions from federal taxable income would also have included certain deductions that are allowed under Montana law:

- up to \$4,700 (up from the existing \$3,600, unadjusted for inflation) of pension and annuity income, reduced by \$2 for every \$1 of federal adjusted gross income over \$60,000 included in either a separate or joint federal income tax return;
- military pay to Montana residents who entered into active duty from Montana and are serving in the regular armed forces (15-30-2117, MCA);
- tip income for services provided at food, beverage, or lodging establishments;
- unemployment compensation included in federal adjusted gross income;

- up to \$3,000 or, if a joint return is filed, up to \$6,000 for contributions to a first-time home buyers savings account, income earned on the account, and eligible withdrawals from the account;
- up to \$3,000 for contributions to a medical savings account, income earned on the account, and eligible withdrawals from the account;
- up to \$3,000 for contributions to a family education savings account; and
- medical or long-term care premium payments made by the taxpayer for the benefit of the taxpayer, the taxpayer's dependents, parents, and grandparents.

The legislation would have required that a joint Montana individual income tax return must be filed in a tax year for which a joint federal income tax return is filed unless one of the individuals is a nonresident.

Each individual, including each nonresident with Montana source income, and each estate or trust would have been required to file a return if required to file a federal income tax return.

The legislation included four rate tables based on filing status. Each rate table contained four brackets. Income bracket amounts would have been adjusted for inflation. For married taxpayers and surviving spouses the tax rate schedule ranged from 4% on the first \$6,000 of taxable income to 6.6% on taxable income in excess of \$125,000.

For head of household taxpayers the tax rate scheduled ranged from 4% on the first \$4,800 of taxable income to 6.6% on taxable income in excess of \$100,000.

For single taxpayers the tax rate schedule ranged from 4% on the first \$3,000 of taxable income to 6.6% on taxable income in excess of \$62,500. The income bracket amounts were one-half of the income bracket amounts for married taxpayers filing a joint return. An identical tax rate schedule applied to married taxpayers who did not file a joint return and to estates and trusts not exempt from taxation under federal law.

According to the SB 173 fiscal note, tax liability for all taxpayers would have increased by a little over \$5 million in the first year, but overall general fund revenue would have decreased by \$4 million because of the repeal of the termination date of the tax credit for the contribution to a qualified endowment.

Without discussion, the proposal was tabled in the Senate Taxation Committee.

### **Individual Income Tax Based on Montana Adjusted Gross Income**

House Bill No. 671 (Ch. 634, L. 1993) was enacted during the 1993 Montana legislative session.

The legislation generally revised individual income tax laws and corporate license tax laws. The new income tax law was expected to increase revenue by around \$60 million over 2 years.

The legislation was a backup plan in case a legislative referendum (Ch. 544, L. 1993) to revise income taxation, impose a sales tax, and provide property tax relief was rejected by the electorate in June 1993. Although the details differed, the income tax provisions contained in the legislative referendum were similar to HB 671.

As enacted, HB 671 would have replaced itemized deductions with standard deduction amounts and higher personal exemption amounts and would have imposed a single income tax rate of 6.75%. As such, the inflation factor to adjust income brackets was eliminated. The legislation would have provided adjustments to the tax rate based on changes to the definition of "federal adjusted gross income" under the Internal Revenue Code.

The standard deduction would have been increased from 20% to 40% of Montana adjusted gross income but could not exceed \$5,000 for a single return or for married taxpayers filing separately on the same form or \$10,000 for married taxpayers filing a joint return. The maximum standard deduction for a head of household would have been \$7,500. The standard deduction would have been adjusted for inflation every tax year.

The standard deduction would have been phased out by 6.25% for every \$5,000 of federal adjusted gross income in excess of \$100,000.

The nominal personal exemption amounts (for taxpayers, dependents, persons at least 65 years of age, and persons who are blind) increased from \$800 to \$2,710. The exemptions would have been adjusted for inflation and the exemptions would have been phased out in the same manner as the standard deduction amount.

The legislation revised slightly the determination of adjusted gross income by excluding federal income tax refund because federal income taxes paid were not deductible.

In addition, married taxpayers filing a joint return would have been allowed to exclude from adjusted gross income an amount, not to exceed \$3,000, equal to 10% of the earned income received by the spouse that earned the least amount of earned income in the tax year. The amount of the exclusion would have been phased out in the same manner as the standard deduction and the exemption amounts.

The legislation would also have increased the corporate license tax rate on corporations, including the tax rate for water's-edge corporations, with taxable income over \$500,000 and would have increased the minimum corporate tax to \$100.

An initiative referendum to overturn the legislation was submitted to the electorate in November 1994. In 1993, supporters of the referendum had gained enough signatures to suspend the effect of the legislation until the election. Montana voters dumped the new income tax scheme by a

margin of almost 3-to-1. The legislative referendum also failed by a 3-to-1 margin. Had the tax reform proposal passed, HB 671 would have been in effect only in tax year 1993.

The legislative proposals described above, especially HB 671, were drafted under different circumstances than exist now, and similar proposals would likely contain significantly different details. However, the main reason for presenting these proposals is to establish a framework for discussing possible options, which may or may not include the alternatives discussed in the memo, for simplifying the state's income tax structure.

CI0425 2103jfqa.