INDIVIDUAL INCOME TAX IN THE UNITED STATES AND MONTANA: A ROADMAP FOR FUTURE COMMITTEE DECISIONS ON HOUSE JOINT RESOLUTION 13 (2011)

Prepared for the Revenue and Transportation Committee

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"The hardest thing in the world to understand is the income tax."[1]
-- Albert Einstein, physicist.

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INTRODUCTION

The purpose of this report is to provide a roadmap for the Revenue and Transportation Interim Committee to evaluate the issues presented in House Joint Resolution No. 13 (HJ 13) from the 2011 Regular Session (contained in Appendix A). This report relies heavily on the Department of Revenue's 2008 – 2010 Biennial Report[2] and citations are provided to relevant pages. The most relevant material to HJ 13 is found in the Individual and Corporate Income Taxes portion and the Tax Expenditures portion of the Biennial Report (contained in Appendix B).

The specific topics covered are as follows:

1) Calculation of federal individual income tax liability;

[1] Internal Revenue Service, *Tax Quotes* (May 20, 2011), *available at* *http://www.irs.gov/newsroom/article/0,,id=110483,00.html* .
[2] Montana Department of Revenue, Biennial Report: July 1, 2008 – June 30, 2010 (2010) (hereinafter Biennial Report).

i. Gross income calculation;
ii. Adjusted gross income;
iii. Itemized vs. standard deduction;
iv. Personal exemptions;
v. Calculation of taxable income;
vi. Tax calculation (rate tables);
vii. Tax credits;

2) Calculation of Montana individual income tax liability;
   i. Montana gross income calculation;
   ii. Montana adjusted gross income and exemptions;
   iii. Montana itemized vs. Montana standard deduction;
   iv. Montana personal exemptions;
   v. Calculation of Montana Taxable income;
   vi. Montana tax calculation (rate tables);
   vii. Montana tax credits;
      a. Nonrefundable credits with no carryover;
      b. Nonrefundable credits with a carryover;
      c. Refundable credits;
      d. The bottom line -- fiscal impact of Montana tax credits;

3) Tax brackets, rates, and filing options in the United States;
   i. 1937-1947: Community property vs. non-community property states and the assignment of income problem;
   ii. 1948-1951: Major change to rate schedule to encourage joint returns and the addition of head of household rates;
   iii. 1968: Single taxpayers protest rate structure and creation of the "marriage tax penalty";
   iv. 2001: Congress revises rate table to mitigate the "marriage tax penalty";
   v. 2009: Modern federal rate structure;
      a. Married individuals and single individuals pay the same lower levels of tax;
      b. Married couples pay more when income increases;
      c. 2007 federal filing statistics;

4) Montana's history of individual income tax filing options, including an analysis of the rationale for allowing married taxpayers to file separately on the same form;
   i. 1933: Enactment of Montana individual income tax;
   ii. 1957: More Montanans required to file a return;
   iii. 1963: Montana joint income tax return provided for by statute;
   iv. 1966-1972: Montana Legislative Council report on Montana taxation;
   v. 1973-1976: Subcommittee on taxation study;
   vi. 1983-1985: Married filing separately on the same form recognized in Montana statute for child and dependent care expenses;
   vii. 1992: Married filing separately on the same form recognized in Montana statute for estimated tax payments;

viii. 2007: Married filing separately on the same form recognized in Montana statute for adoption tax credit;
ix. Montana's current rate structure encourages most married couples to file separately on the same form; and

5) Individual Income Tax Provisions in the States: The Wisconsin Legislative Fiscal Bureau publication (contained in Appendix D).

1. INDIVIDUAL INCOME TAX IN THE UNITED STATES

In 2009, Montana was one of 43 states with an individual income tax.[3] However, in order to understand Montana income tax a basic understanding of the federal individual income tax[4] is necessary. As such, this section provides a very brief overview of the federal individual income tax system. Federal individual income tax liability is generally calculated by taking into account the following major steps:

1. Determine **gross income**;
2. Determine **adjusted gross income** (above the line deductions or AGI) by subtracting certain "super" deductions from gross income;
3. Calculate allowable **itemized deductions** (below the line deductions);
    a. Note: The itemized deduction calculations can be dependent on the adjusted gross income calculation.
    b. Note: Certain itemized deductions are limited by statute and may be eliminated for the failure to meet a certain percentage of AGI, or may be reduced or phased out based on AGI being too high.
    c. Note: Typically taxpayers reduce AGI by the higher of the itemized deductions or the **standard deduction** (specific dollar amount in statute) – see step 5.
4. Determine the **personal exemption** deduction;
5. Calculate **taxable income** as follows:
    AGI minus (higher of itemized deductions **or** standard deduction **plus** personal exemption);
6. Apply the progressive tax rate structure (the more you make the higher the percentage of tax) against taxable income using tax tables in order to determine tax liability; and
7. Calculate the amount of refund or amount of tax that is remitted to the IRS by subtracting wage withholdings and any allowable tax credits from the tax figure derived from step 6.

i. Step 1: Gross Income Calculation

[3] Rick Olin and Sandy Swain, Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States*, at 1 (Jan. 2011).
[4] The Sixteenth Amendment to the United States Constitution authorizing an unapportioned income tax was adopted on March 1, 1913. Eight months after the amendment, Congress passed a statute that taxed individual income at a rate of 1%, with progressive surtaxes when net income exceeded $20,000.

Section 61(a) of the Internal Revenue Code of 1986 (I.R.C.)[5] provides that unless provided otherwise gross income "means all income from whatever source derived". The United States Supreme Court, in *Commissioner v. Glenshaw Glass Co.*, determined that the definition of gross income is broad and that Congress intended to exert "the full measure of its taxing power".[6] Congress has defined the criteria as "including (but not limited to) the following items:

> (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
> (2) Gross income derived from business;
> (3) Gains derived from dealings in property;
> (4) Interest;
> (5) Rents;
> (6) Royalties;
> (7) Dividends;
> (8) Alimony and separate maintenance payments;
> (9) Annuities;
> (10) Income from life insurance and endowment contracts;
> (11) Pensions;
> (12) Income from discharge of indebtedness;
> (13) Distributive share of partnership gross income;
> (14) Income in respect of a decedent; and
> (15) Income from an interest in an estate or trust."[7]

The federal system is one that taxes gains and profits, not gross receipts. As such, in calculating gross income the cost of goods sold for manufacturing, merchandising, and mining businesses is subtracted from gross receipts in order to determine gross income.[8]

ii. Step 2: Adjusted Gross Income

Section 62(a) of the I.R.C. defines adjusted gross income (AGI) as gross income minus certain specific deductions, most of which contain restrictions that are detailed in other

[5] The Internal Revenue Code is codified in Title 26 of the United States Code.
[6] *Commissioner v. Glenshaw Glass,* 348 U.S. 426, 429 (1955).
[7] I.R.C. § 61.
[8] Treas. Reg. § 1.61-3(a) provides: "In general. In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in § 1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162(c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see § 1.446-1(c)(1)(ii))."

code sections. The deductions listed in section 62 are often referred to as "above the line" deductions. Generally, these deductions include:

> (1) Trade and business deductions that are attributable to a trade or business carried on by the taxpayer if such trade or business does not consist of the performance of services by the taxpayer as an employee (*see* I.R.C. § 162 and I.R.S. Form 1040 – Schedule C)[9];
> (2) Certain trade and business deductions of certain employees;
> (3) Losses from sale or exchange of property;
> (4) Deductions attributable to rents and royalties;
> (5) Certain deductions of life tenants and income beneficiaries of property;
> (6) Pension, profit-sharing, and annuity plans of self-employed individuals (*see* I.R.C. § 404 and Biennial Report, p. 211, table 2.6);
> (7) Retirement savings (*see* I.R.C. § 219 and Biennial Report, p. 209, table 2.3);
> (8) Penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits (I.R.C. § 165);
> (9) Alimony (*see* I.R.C. § 215);
> (10) Reforestation expenses (*see* I.R.C. § 194);
> (11) Certain required repayments of supplemental unemployment compensation benefits (*see* I.R.C. § 165);
> (12) Jury duty pay remitted to employer;
> (13) Deduction for clean-fuel vehicles and certain refueling property (*see* I.R.C. § 179A);
> (14) Moving expenses (*see* I.R.C. § 217);
> (15) Archer MSAs (*see* I.R.C. § 220);
> (16) Interest on education loans (*see* I.R.C. § 221 and Biennial Report, p. 210, table 2.4);
> (17) Higher education expenses (*see* I.R.C. § 222 and Biennial Report, p. 210, table 2.5);
> (18) Health savings accounts (*see* I.R.C. § 223 and Biennial Report, p. 209, table 2.2);
> (19) Costs involving discrimination suits, etc;
> (20) Attorney fees relating to awards to whistleblowers;
> (21) One-half self-employment tax (*see* Biennial Report, p. 211, table 2.6);
> (22) Self-employed health insurance deduction (*see* Biennial Report, p. 211, table 2.6); and
> (23) Domestic production activities deduction (*see* Biennial Report, p. 211, table 2.7).

The concept of AGI dates back to World War II, when individuals were able to itemize all of their deductions, both business and personal.[10] During this timeframe the number of taxpayers that were required to file income tax returns increased enough that it became an administrative problem for the IRS to review returns. As such, in 1944 Congress gave

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[9] *See* I.R.C. § 162(a) (providing a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business).
[10] *See* United States Internal Revenue, *1943 Form 1040*, at 1.

taxpayers the option of claiming a standard deduction for personal expenses while at the same time allowing taxpayers to deduct actual trade or business expenses. AGI continues as a concept today, and individual taxpayers are allowed to deduct above the line deductions regardless of whether they itemize or claim the standard deduction. However, the term AGI includes more than just business expenses. Moreover, AGI is a key element in determining the extent of itemized deductions that are allowed.

iii. Step 3: Itemized vs. Standard Deduction

Not all deductions are related to the production of income. Some deductions exist based on economic and social policies of Congress. In order for a taxpayer to take a deduction, it must be allowed by a specific code section. A taxpayer must determine whether to take the itemized deductions or the standard deduction.[11] In most cases federal income tax will be less if a taxpayer takes the larger of the itemized deductions or the standard deduction. The following were common itemized deductions for tax year 2010, all of which are claimed on IRS Form 1040 - Schedule A:

(1) Medical and dental expenses not reimbursed or paid by others, including travel to get medical care (must be over 7.5% of AGI before it can be claimed – portion that is under 7.5% of AGI cannot be deducted).
(2) Taxes paid by the taxpayer including state income or sales taxes, real estate taxes, certain mandatory contributions to state funds, and certain motor vehicle taxes (cannot deduct federal income taxes, social security, Medicare, and federal unemployment insurance).
(3) Home mortgage interest deduction on main home or second home, mortgage insurance premiums, and points.[12]
(4) Gifts to charity.
(5) Casualty and theft losses.
(6) Job expenses that cannot be claimed as above the line deductions and certain miscellaneous deductions including unreimbursed employee expenses, tax preparation fees, and investment expenses (must be over 2% of AGI before it can be claimed – portion that is under 2% of AGI cannot be deducted).

The fact that a taxpayer had expenses does not automatically mean that all of the expenses can be deducted. In the case of medical and dental expenses, a taxpayer is not entitled to take a deduction until expenses exceed 7.5% of AGI. For example, if a taxpayer had $100,000 AGI in tax year 2010 then $7,500 in medical and dental expenses could not be deducted, but everything above $7,500 in medical expenses could be deducted. Starting in 2012 this threshold is increased to 10% of AGI, but taxpayers 65 and older will be able to deduct expenses that exceed 7.5% of AGI through 2016.[13]

[11] Generally, the standard deduction for tax year 2010 was $5,700 for single or married filling separately, $11,400 for married filing jointly, and $8,400 for head of household. United States Internal Revenue, *2010 Instructions for Form 1040*, at 33.
[12] United States Internal Revenue, *2010 Instructions for Schedule A (Form 1040)*, at A-8.
[13] I.R.C. § 213(a) amended by Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9013, 124 Stat. 119 (2010) (striking 7.5 percent and inserting 10 percent.).

Additionally, some itemized deductions are limited and a taxpayer's ability to utilize them can fade. For example, a married couple filing jointly with AGI of more than $100,000 in tax year 2010 would need to reduce any qualified mortgage insurance deduction and the deduction would be completely eliminated once AGI reaches $109,000.[14]

iv. Step 4: Personal Exemptions

As the name implies, a taxpayer is exempt from paying income tax on a certain amount of income.[15] The personal exemption is adjusted for inflation and is calculated by multiplying the dollar amount of the exemption by the number of exemptions (*i.e.*, taxpayer, spouse, children, dependents). For example, a family of four would be entitled to an exemption of $14,600 ($3,650 x 4) in tax year 2010.[16] In the past this exemption has been subject to a phaseout amount whereby a taxpayer with AGI above a "threshold amount" of $150,000 would face a reduction in the exemption.[17] The personal exemption is essentially a floor that assures a taxpayer will not be taxed unless income is greater than the exemption.

v. Step 5: Calculate Taxable Income

Taxable income is calculated using AGI, the higher of itemized deductions or the standard deduction, and allowable personal exemptions.[18] For example taxable income for a family of four filing a married filing joint return with $100,000 AGI and $20,000 in itemized deductions would be calculated as follows:

AGI:	$100,000	
Minus: Itemized Deduction	- $ 20,000	(the Standard Deduction was $11,400 in 2010)
Minus: Personal Exemptions	- <u>$ 14,600</u>	($3,650 x 4 in 2010)
TAXABLE INCOME	= $ 65,400	

This would appear as follows on Form 1040:

Form 1040 (2010) Page **2**

Tax and Credits	38	Amount from line 37 (adjusted gross income)	38	100,000
	39a	Check if: ☐ **You** were born before January 2, 1946, ☐ Blind. ☐ **Spouse** was born before January 2, 1946, ☐ Blind. **Total boxes checked ▶ 39a** ☐		
	b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b☐		
	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see instructions)	40	20,000
	41	Subtract line 40 from line 38	41	80,000
	42	**Exemptions.** Multiply $3,650 by the number on line 6d	42	14,600
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	65,400

[14] United States Internal Revenue, *2010 Instructions for Schedule A (Form 1040)*, at A-8.
[15] I.R.C. § 151.
[16] The exemption is $3,700 for tax year 2011. Rev. Proc. 2011-12, § 2.07(1).
[17] I.R.C. § 151(d)(3).
[18] *See* I.R.C. § 63(a)-(b).

vi. Step 6: Tax Calculation

As discussed in further detail in section 3 of this paper, different brackets exist depending on filing status. The income levels are adjusted annually by the U.S. Secretary of the Treasury to allow for a cost-of-living adjustment using the Consumer Price Index.[19] Generally, the more taxable income you have, the higher your rate of tax. For example, the following are examples of brackets in tax years 2001, 2006, and 2011:

Tax Year 2001

For tax years beginning in 2001, the tax rate table was as follows for Married Individuals Filing Joint Returns and Surviving Spouses:

If Taxable Income Is:	The Tax Is:
Not Over $45,200	15% of the taxable income
Over $45,200 but not over $109,250	$6,780.00 plus 28% of the excess over $45,200
Over $109,250 but not over $166,500	$24,714.00 plus 31% of the excess over $109,250
Over $166,500 but not over $297,350	$42,461.50 plus 36% of the excess over $166,500
Over $297,350	$89,567.50 plus 39.6% of the excess over $297,350[20]

Tax Year 2006

For tax year 2006**,** the tax rate table was as follows for Married Individuals Filing Joint Returns and Surviving Spouses:

If Taxable Income Is:	The Tax Is:
Not over $ 15,100	10% of the taxable income
Over $ 15,100 but not over $ 61,300	$ 1,510 plus 15% of the excess over $ 15,100
Over $ 61,300 but not over $ 123,700	$ 8,440 plus 25% of the excess over $ 61,300
Over $ 123,700 but not over $ 188,450	$ 24,040 plus 28% of the excess over $ 123,700
Over $ 188,450 but not over $ 336,550	$ 42,170 plus 33% of the excess over $ 188,450
Over $ 336,550	$ 91,043 plus 35% of the excess over $ 336,550[21]

[19] *See* I.R.C. § 1(f).
[20] Rev. Proc. 2001-13, § 3.01 (Jan. 16, 2001):
[21] Rev. Proc. 2005-70, § 3.01 (Nov. 21, 2005):

Tax Year 2011

For tax year 2011, the tax rate table is as follows for Married Individuals Filing Joint Returns and Surviving Spouses:

If Taxable Income Is:	The Tax Is:
Not over $17,000	10% of the taxable income
Over $17,000 but not over $69,000	$1,700 plus 15% of the excess over $17,000
Over $69,000 but not over $139,350	$9,500 plus 25% of the excess over $69,000
Over $139,350 but not over $212,300	$27,087.50 plus 28% of the excess over $139,350
Over $212,300 but not over $379,150	$47,513.50 plus 33% of the excess over $212,300
Over $379,150	$102,574 plus 35% of the excess over $379,150[22]

The easiest way to calculate total tax is to use the tax tables published by the IRS in the instructions to Form 1040. These tables have already taken into account the progressive rates of tax, cost-of-living adjustments, and filing status. For example, using taxable income of $65,400 in the above example the married couple would have a tax of $8,976 in tax year 2010.

2010 Tax Table—*Continued*

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
		Your tax is—			
65,000					
65,000	65,050	12,438	8,916	12,438	11,104
65,050	65,100	12,450	8,924	12,450	11,116
65,100	65,150	12,463	8,931	12,463	11,129
65,150	65,200	12,475	8,939	12,475	11,141
65,200	65,250	12,488	8,946	12,488	11,154
65,250	65,300	12,500	8,954	12,500	11,166
65,300	65,350	12,513	8,961	12,513	11,179
65,350	65,400	12,525	8,969	12,525	11,191
65,400	65,450	12,538	8,976	12,538	11,204
65,450	65,500	12,550	8,984	12,550	11,216
65,500	65,550	12,563	8,991	12,563	11,229
65,550	65,600	12,575	8,999	12,575	11,241
65,600	65,650	12,588	9,006	12,588	11,254
65,650	65,700	12,600	9,014	12,600	11,266
65,700	65,750	12,613	9,021	12,613	11,279
65,750	65,800	12,625	9,029	12,625	11,291
65,800	65,850	12,638	9,036	12,638	11,304
65,850	65,900	12,650	9,044	12,650	11,316
65,900	65,950	12,663	9,051	12,663	11,329
65,950	66,000	12,675	9,059	12,675	11,341

[23]

There is one major exception to the above rates. Section 1(h) of the Internal Revenue Code gives taxpayers preferential treatment for certain capital gains. The determination of whether a taxpayer has a capital gain depends on whether the taxpayer has a capital asset.[24] In the event a taxpayer has capital gains, a variety of calculations need to be performed to determine whether the gains were short term (year or less), long term (longer than 1 year), or both. Additionally, there are limitations on the deductibility of capital losses. Generally speaking, long-term capital gains receive preferential treatment

[22] Rev. Proc. 2011-12, § 2.01 (Mar. 29, 2010):
[23] United States Internal Revenue, *2010 Instructions for Form 1040*, at 81.
[24] I.R.C. § 1221.

while short-term capital gains do not. An overview of these issues goes beyond the scope of this paper.

vii. Step 7: Tax Credits

The final computation deals with applying tax credits and payments made through withholdings or estimated payments toward the tax in order to determine the size of the refund or the amount of money due. Tax credits are more powerful than deductions as they typically offset tax dollar for dollar, whereas deductions only offset income. For example, a $1,000 deduction could put an additional $100 to $350 (assuming 10% through 35% tax brackets) in a taxpayer's pocket, while a $1,000 tax credit could put $1,000 in the taxpayer's pocket regardless of income. The following were some of the federal credits for tax year 2010 (see 2010 IRS Form 1040, lines 47 – 54 and 61 – 72):

(1) Foreign tax credit (2010 IRS Form 1116);
(2) Credit for child and dependent care expenses (2010 IRS Form 2441);
(3) Education credits (2010 IRS Form 8863);
(4) Retirement savings contribution credit (2010 IRS Form 8880);
(5) Child tax credit (2010 Instructions for Form 1040, pp. 39 – 41);
(6) Residential energy credits (2010 IRS Form 5695);
(7) General business credits claimed on 2010 IRS Form 3800, including:
    a. Investment credit;
    b. Increasing research activities;
    c. Low-income housing credit;
    d. Disabled access credit;
    e. Renewable electricity production credit;
    f. Indian employment credit;
    g. Orphan drug credit;
    h. New markets credit;
    i. Credit for small employer pension plan startup costs;
    j. Credit for employer-provided child care facilities and services;
    k. Biodiesel and renewable diesel fuels credit;
    l. Low sulfur diesel fuel production credit;
    m. Distilled spirits credit;
    n. Nonconventional source fuel credit;
    o. Energy-efficient home credit;
    p. Energy-efficient appliance credit;
    q. Alternative motor vehicle credit;
    r. Alternative fuel vehicle refueling property credit;
    s. Employer housing credit;
    t. Mine rescue team training credit;
    u. Agricultural chemicals security credit;
    v. Credit for employer differential wage payments;
    w. Carbon dioxide sequestration credit;
    x. Qualified plug-in electric drive motor vehicle credit;
    y. Qualified plug-in electric vehicle credit;

z. New hire retention credit;
aa. Passive activity credits;

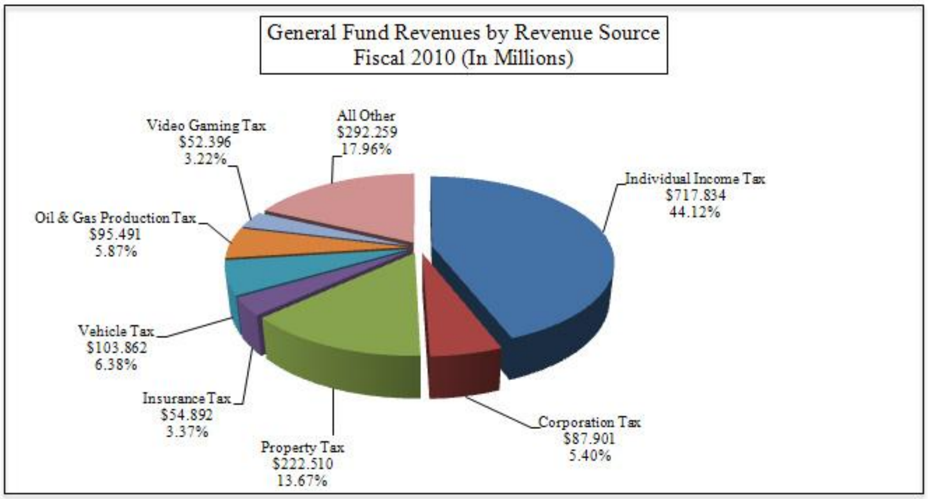
(8) Credit for prior year minimum tax claimed on 2010 IRS Form 8801;
(9) Federal income tax withheld on IRS Forms W-2 and 1099;
(10) Making work pay credit (2010 IRS Schedule M);
(11) Earned income credit (2010 IRS Schedule EIC);
(12) Nontaxable combat pay election (2010 Instructions for Form 1040, p. 47);
(13) Additional child tax credit (2010 IRS Form 8812);
(14) American opportunity credit (2010 IRS Form 8863);
(15) First-time homebuyer credit (2010 IRS Form 5405);
(16) Excess social security tax withheld (2010 Instructions for Form 1040, p. 69);
(17) Credit for federal tax on fuels (2010 IRS Form 4136); and
(18) Qualified adoption expenses (2010 IRS Form 8839).

Similar to deductions, credits can be phased out based on income and the ability to utilize a credit in full can depend on a variety of facts and circumstances.

2. INDIVIDUAL INCOME TAX IN MONTANA

Montana enacted a graduated income tax in 1933 during the Great Depression, and it is currently the largest source of state tax revenue. As enacted, a "taxpayer" was defined as any person or fiduciary.[25] A person, in turn, was required to "make, under oath, a return stating specifically the items of his gross income and the deductions and credits allowed."[26] However, the tax return requirement did not kick in unless the person had a certain level of income. Specifically, a single person (or married but not living with or supporting a husband, wife, or family) was entitled to earn $999.99 net income before the filing requirement came into play, while a married person who was living with the other spouse was entitled to earn $1,999.99 net income. However, if both of the spouses earned income the statute provided that no more than $2,499.99 in "aggregate net income" could be earned before a return was required.[27]

[25] Sec. 1, Ch. 181, L. 1933.
[26] *Id.* § 14.
[27] *Id.* There were also gross income guidelines.



[28]

The structure of Montana's personal income tax is based upon federal tax law. As such, whenever Congress adds another exclusion or deduction the same feature can automatically appear (*i.e.*, rolling conformity) in the Montana income tax without any action from the Legislature. For tax year 2010 the Internal Revenue Code was referenced at least 30 times in Montana's Individual Income Tax Code (Title 15, Chapter 30, MCA). When a reference appears to a specific provision of the Internal Revenue Code it encompasses "those provisions as they may be otherwise labeled or further amended." § 15-30-2101, MCA. Additionally, in the event a term is not defined in Montana law "the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code". § 15-30-2620(2), MCA.

A tie to the federal system reduces the Department's (DOR's) costs of administering the income tax and taxpayers' costs of complying.[29] However, one could make the argument that an automatic tie to the federal system as amended is an unlawful delegation of legislative authority. During the 2007 -2008 interim this committee reviewed state conformity with federal income tax laws as part of the House Joint Resolution No. 61 (2007) study. A staff outline (see Appendix C) highlighted the following issues regarding automatic conformity with the federal system:

- "Rolling" conformity changes the question from "shall we conform?" to "shall we nonconform?" (if the question comes up at all)
- Delegation of legislative authority (see related Legislative Services staff attorney report regarding this issue in Appendix C)
- Federal policy affects state policy
- Taxpayer convenience and compliance

The outline highlighted further the following issues to consider regarding adoption of provisions of the Internal Revenue Code on a specific date (*i.e.*, fixed date conformity):

[28] Montana Legislative Fiscal Division, General Fund Revenues by Revenue Source Fiscal 2010.
[29] Montana Department of Revenue, Biennial Report: July 1, 2008 – June 30, 2010, p. 54 (2010).

- If nonconformity involves a known amount then complexity not a problem
- Nonconforming to depreciation--2 sets of books, different basis, recognize different amounts on disposition--more complex for multistate taxpayers
- Complexity may compel conformity, e.g. determining basis of IRAs

i. Step 1: Montana Gross Income Calculation

The Montana income tax starts by adopting the federal concept of gross income. Pursuant to § 15-30-2101, MCA, gross income "means the taxpayer's gross income for federal income tax purposes as defined in section 61 of the Internal Revenue Code (26 U.S.C. 61) or as that section may be labeled or amended, excluding unemployment compensation included in federal gross income under the provisions of section 85 of the Internal Revenue Code (26 U.S.C. 85) as amended." As stated above, the federal definition of gross income is comprehensive. Likewise, the Montana definition of gross income is comprehensive.

ii. Step 2: Montana Adjusted Gross Income and Exemptions

The Montana definition of adjusted gross income has evolved substantially since 1933. Pursuant to § 15-30-2110, MCA, except as otherwise provided "adjusted gross income is the taxpayer's federal adjusted gross income as defined in section 62 of the Internal Revenue Code, 26 U.S.C. 62". Consequently, decisions of Congress can have a direct impact on Montana AGI. However, there are multiple items that are specifically included in Montana AGI regardless of what Congress does. These Montana additions include:

(1) Interest and mutual fund dividends from state, county, or municipal bonds from other states (*see* § 15-30-2110(1)(a)(i), MCA);
(2) Dividends not included in federal adjusted gross income (*see* § 15-30-2110(1)(a)(ii), MCA);
(3) Taxable federal refunds (*see* § 15-30-2110(1)(b), MCA);
(4) Other recoveries of amounts deducted in earlier years that reduced Montana taxable income – primarily refunds of federal taxes previously deducted (*see* § 15-30-2110(1)(e), MCA);
(5) Addition to federal taxable social security (*see* § 15-30-2101(18)(a)(xiv), MCA);
(6) Sole proprietor's allocation of compensation to spouse;
(7) Medical care savings account nonqualified withdrawals (*see* §§ 15-61-101 through 15-61-205, MCA, and Biennial Report, pp. 217-218, tables 2.22 and 2.23);
(8) First-time home buyer savings account nonqualified withdrawals (*see* §§ 15-63-101 through 15-63-205, MCA, and Biennial Report, pp. 218-219, tables 2.24 and 2.25);
(9) Farm and ranch risk management account taxable distributions (*see* §§ 15-30-3001 through 15-30-3005, MCA, and Biennial Report, pp. 219-220, tables 2.27 and 2.28);

(10) Addition for dependent care assistance credit adjustment;
(11) Addition for smaller federal estate and trust taxable distributions (*see* § 15-30-2110(1)(f), MCA);
(12) Federal net operating loss carryover;
(13) Share of federal income taxes paid by an S corporation (*see* § 15-30-2110(1)(c), MCA);
(14) Title plant depreciation and amortization (*see* § 15-30-2110(1)(d), MCA); and
(15) Premiums for Insure Montana Small Business Health Insurance credit.

According to the DOR's Biennial Report, some Montana additions to federal AGI were used regularly, while other additions were used sparingly. The Biennial Report (page 58) contains the following statistics based on full-year residents' returns:

Montana Individual Income Tax Income Reported on Full-Year Residents' Returns 2008 and 2009				
	2008		2009	
	Count	Total	Count	Total
Montana Additions to Federal Adjusted Gross Income				
Interest on other states' municipal bonds	17,321	94,380,505	17,681	92,212,666
Dividends not included in FAGI	155	221,776	441	702,870
Taxable federal refunds	90,034	122,652,586	83,066	122,976,647
Recoveries of amounts deducted in earlier years	833	468,721	285	973,921
Additions to federal taxable social security or railroad retirement	6,133	9,379,800	6,722	10,706,356
Allocation of compensation to spouse	611	9,563,306	482	7,202,972
Medical savings account nonqualified withdrawals	109	145,198	113	129,357
First-time homebuyer's account nonqualified withdrawals	8	35,384	14	29,691
Farm and ranch risk management account taxable distributions	1	200	1	697
Dependent care assistance credit adjustment	52	86,959	67	127,529
Smaller federal estate and trust taxable distributions	39	48,095	70	115,517
Federal net operating loss carryover	3,592	190,896,793	4,128	256,422,918
Federal taxes paid by your S. corporation	15	326,001	42	74,002
Title plant depreciation	0	0	2	3,548
Group health premiums reimbursed by Insure Montana credit	769	4,642,233	919	5,094,962
Other additions	7,371	99,710,548	4,922	113,864,663
Total Montana Additions	117,840	532,558,105	109,059	610,638,316

There are also multiple items that are specifically subtracted in Montana AGI regardless of what Congress does. These Montana subtractions include:

(1) Exempt interest and mutual fund dividends from federal bonds, notes, and obligations (*required under federal law - see* Biennial Report, p. 212, table 2.8);
(2) Exempt tribal income (*required under federal law - see* Biennial Report, p. 212, table 2.9);
(3) Exempt unemployment compensation (*see* Biennial Report, p. 213, table 2.10);
(4) Exempt workers' compensation benefits (*see* Biennial Report, p. 213, table 2.11);
(5) Exempt capital gains and dividends from small business investment companies (*see* Biennial Report, p. 214, table 2.12);
(6) State income tax refunds included in federal AGI calculation;
(7) Recoveries of amounts deducted in earlier years that did not reduce Montana income tax;

(8) Exempt military salary of residents on active duty (*see* Biennial Report, p. 214, table 2.13);
(9) Exempt income of nonresident military servicepersons (*see* Biennial Report, p. 214, table 2.14);
(10) Exempt life-insurance premiums reimbursement for National Guard and Reservist (*see* Biennial Report, p. 215, table 2.15);
(11) Partial pension and annuity income exemption (*see* Biennial Report, p. 215, table 2.16);
(12) Partial interest exemption for taxpayers 65 and older (*see* Biennial Report, p. 215-216, table 2.17);
(13) Partial retirement disability income exemption for taxpayers under age 65 (*see* Biennial Report, p. 215-216, table 2.18);
(14) Exemption for certain taxed tips and gratuities (*see* Biennial Report, p. 216, table 2.19);
(15) Exemption for certain income of child taxed to parent (*see* § 15-30-2110(2)(p), MCA);
(16) Exemption for certain health insurance premiums taxed to employee (*see* § 15-30-2110(2)(h), MCA and Biennial Report, pp. 216-217, table 2.20);
(17) Exemption for student loan repayments taxed to health care professional (*see* § 15-30-2110(12), MCA, and Biennial Report, p. 217, table 2.21);
(18) Exempt medical care savings account deposits and earnings (*see* §§ 15-61-101 through 15-61-205, MCA, and Biennial Report, pp. 217-218, tables 2.22 and 2.23);
(19) Exempt first-time home buyer savings account deposits and earnings (*see* §§ 15-63-101 through 15-63-205, MCA, and Biennial Report, pp. 218-219, tables 2.24 and 2.25);
(20) Exempt family education savings account deposits (*see* §§ 15-62-101 through 15-62-302, MCA, and Biennial Report, p. 219, table 2.26);
(21) Exempt farm and ranch risk management account deposits (*see* §§ 15-30-3001 through 15-30-3005, MCA, and Biennial Report, pp. 219-220, tables 2.27 and 2.28);
(22) Subtraction from federal taxable social security/Tier I Railroad Retirement reported in federal AGI calculation (*see* Biennial Report, p. 220);
(23) Subtraction for federal taxable Tier II Railroad Retirement benefits reported in federal AGI calculation (*required under federal law - see* Biennial Report, p. 220, table 2.29);
(24) Passive loss adjustment;
(25) Capital loss adjustment;
(26) Subtraction of sole proprietor for allocation of compensation to spouse;
(27) Montana net operating loss carryover;
(28) 40% capital gain exclusion for pre-1987 installment sales (*see* § 15-30-2110(13), MCA, and Biennial Report, pp. 220-221, table 2.30);
(29) Subtraction for business related expenses for purchasing recycled material (*see* §§ 15-32-609 through 15-32-611, MCA, and Biennial Report, p. 221, table 2.30);

(30) Subtraction for sales of land to beginning farmers (*see* § 80-12-211, MCA, and Biennial Report, p. 221, table 2.32);
(31) Subtraction for larger federal estate and trust taxable distribution;
(32) Subtraction for wage deduction reduced by federal targeted jobs credit; and
(33) Subtraction for certain gains recognized by liquidating corporation.

According to the DOR's Biennial Report, some Montana subtractions from federal AGI were used regularly, while other subtractions were used sparingly. The Biennial Report (page 58) contains the following statistics based on full-year residents' returns:

Montana Individual Income Tax Income Reported on Full-Year Residents' Returns 2008 and 2009				
	2008		2009	
	Count	Total	Count	Total
Montana Subtractions from Federal Adjusted Gross Income				
Federal bonds exempt interest	28,534	51,862,384	23,963	37,421,242
Exempt tribal income	7,409	187,639,734	7,735	201,760,096
Exempt unemployment compensation	30,268	99,748,626	32,500	169,813,215
Exempt worker's comp benefits	77	400,335	204	1,006,241
Capital gains from small business investment companies	49	50,125	50	73,145
State tax refunds included in federal AGI	109,494	105,479,553	106,869	118,187,520
Recoveries of amounts deducted in earlier years	37	67,983	22	102,536
Exempt active duty military salary	4,142	131,691,515	4,297	142,046,880
Nonresident exempt military income	112	3,661,691	99	3,560,669
Exempt life insurance premiums reimbursement (National Guard)	126	447,340	41	441,796
Exempt pension income	42,005	134,023,768	41,280	132,876,584
Elderly interest exclusion	72,327	46,871,599	70,449	43,632,908
Exempt retirement disability income (under age 65)	91	369,876	155	656,765
Exempt tip income	11,142	31,562,631	13,348	38,921,676
Exempt income of child taxed to parent	145	251,424	44	99,782
Exempt health insurance premiums taxed to employee	283	1,127,728	160	644,902
Student loan repayments taxed to health care professional	102	294,799	134	370,976
Medical care savings account exempt deposits	7,524	16,967,593	7,425	17,483,938
First-time homebuyer exempt savings account deposits	196	538,398	254	710,124
Family education savings account exempt deposits	2,913	6,854,175	2,741	6,592,192
Farm and ranch risk management accounts exempt deposits	0	0	0	0
Subtraction to federal taxable social security/Tier 1 railroad retirement	31,901	104,252,490	32,847	113,084,380
Subtraction for federal taxable Tier II railroad retirement	3,054	35,527,084	3,025	36,473,121
Subtraction for spouse filing joint return: passive loss carryover	713	4,913,234	76	244,075
Subtraction for spouse filing joint return: capital loss adjustment	1,828	1,918,568	2,481	3,554,062
Allocation of compensation to spouse	611	9,564,024	502	7,418,488
Montana net operating loss carryover	3,397	177,036,342	3,867	242,163,391
40% capital gain exclusion on pre-1987 installment sales	626	2,813,975	250	1,124,567
Business expense of recycled material	72	179,028	115	136,675
Sales of land to beginning farmers	1	2,270	2	7,785
Larger federal estate and trust taxable distributions	153	311,890	110	264,183
Wage deduction reduced by federal targeted jobs credit	58	199,915	63	276,616
Certain gains recognized by liquidating corporation	13	399,697	5	29,686
Other subtractions	4,373	108,699,708	4,154	126,816,297
Total Montana Subtractions	246,009	1,265,729,502	243,960	1,447,996,513

Section 15-30-2110, MCA, is a lengthy provision that has been amended 49 times since 1933. It is also a provision that can have a big impact on tax policy, what taxpayers pay, and general fund revenue.

iii. Step 3: Montana Itemized vs. Montana Standard Deduction

Similar to the federal income tax, Montana allows taxpayers to choose between itemized deductions or a standard deduction.[30] Generally Montana income tax will be less if a taxpayer takes the larger of the itemized deductions or the standard deduction. The determination of what is allowed for purposes of claiming itemized deductions starts out with a reference to the federal tax code. Pursuant to § 15-30-2131, MCA, the items

[30] I.R.C. § 63(b), (e); § 15-30-2132(1), MCA.

referred to in I.R.C. sections 161 and 211 are deductible, with some exceptions. Additionally, Montana taxpayers are allowed to take some deductions regardless of what Congress does. The following deductions are **not allowed** as itemized deductions (computing net income), regardless of what Congress does:

(1) Personal, living, or family expenses (§§ 15-30-2131(1)(a)(i), 15-30-2133(1), MCA);
(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate (§§ 15-30-2131(1)(a)(i), 15-30-2133(2), MCA);
(3) Any amount expended in restoring property or in making good the exhaustion of the property for which an allowance is or has been made (§§ 15-30-2131(1)(a)(i), 15-30-2133(3), MCA);
(4) Premiums paid on any life insurance policy covering the life of any officer or employee or of any person financially interested in any trade or business carried on by the taxpayer when the taxpayer is directly or indirectly a beneficiary under the policy (§§ 15-30-2131(1)(a)(i), 15-30-2133(4), MCA);
(5) Expenses that are generally associated with the production of exempt or excludable income (§§ 15-30-2131(1)(a)(i), 15-30-2133(4), MCA);
(6) State income taxes paid (§ 15-30-2131(1)(a)(ii), MCA); and
(7) A charitable contribution using a charitable gift annuity unless the annuity is a qualified charitable gift annuity under Montana law (§§ 15-30-2131(1)(a)(v), and 33-20-701, MCA).

The following deductions are **allowed** as itemized deductions (computing net income), regardless of what Congress does:

(1) Federal income tax paid within the tax year, not to exceed $5,000 for each taxpayer filing singly, head of household, or married filing separately or $10,000 if married and filing jointly (§ 15-30-2131(1)(b), MCA);
(2) Subject to a variety of limitations, expenses of household and dependent care services (§ 15-30-2131(1)(c), MCA);
(3) Political contributions determined in accordance with the provisions of section 218(a) and (b) of the Internal Revenue Code of 1954 (now repealed) that were in effect for the tax year that ended December 31, 1978 (§ 15-30-2131(1)(d), MCA);
(4) That portion of expenses for organic fertilizer and inorganic fertilizer produced as a byproduct and not otherwise deducted in computing taxable income (§ 15-30-2131(1)(e), MCA);
(5) Subject to conditions, contributions to the child abuse and neglect prevention program (§ 15-30-2131(1)(f), MCA);
(6) The entire amount of premium payments made by the taxpayer, except premiums deducted in determining Montana adjusted gross income, or for which a credit was claimed for qualified elderly care expenses (§ 15-30-2131(1)(g), MCA);
(7) Montana light vehicle registration fees (§ 15-30-2131(1)(h), MCA);

(8) Montana per capita livestock fees (§ 15-30-2131(1)(i), MCA);
(9) Donations to the veterans' services account and the state veterans' cemetery program and the patriotic license plate surcharge (§ 15-30-2142, MCA).

According to the DOR's Biennial Report, some Montana income tax deductions were used regularly, while other subtractions were used sparingly. The Biennial Report (page 59) contains the following statistics based on full-year residents' returns:

Montana Individual Income Tax Deductions Reported on Full-Year Residents' Returns 2008 and 2009

	2008		2009	
	Count	Total	Count	Total
Deductions				
Total medical expenses*	134,614	550,903,057	133,123	543,571,282
Deductible medical expenses	71,687	309,033,065	73,337	307,848,323
Medical insurance premiums not deducted elsewhere	102,280	328,606,170	103,054	345,055,072
Long-term care insurance premiums	13,640	26,552,393	13,264	26,195,277
Federal Income Tax				
Federal income tax withheld*	249,756	1,439,217,079	250,431	1,325,630,593
Federal income tax estimated payments*	55,434	761,008,071	50,339	573,787,410
Last year's federal income tax paid (e.g. with return)*	68,313	360,705,773	52,432	280,037,049
Federal income tax from previous years*	5,147	22,571,910	4,094	36,809,791
Federal economic stimulus rebate	256,154	543,735,650	n/a	n/a
Total federal income tax deduction (after $5,000 cap)	262,564	977,041,035	280,813	1,007,165,809
State or Local Sales Tax**	n/a	n/a	577	621,978
Local income taxes	132	104,485	228	208,407
Real estate taxes	209,253	375,863,167	211,054	390,523,795
Personal property taxes	169,593	54,112,119	164,852	53,773,266
Other deductible taxes	22,848	8,494,096	26,256	8,631,187
Home mortgage interest	161,357	1,151,150,074	160,899	1,114,955,415
Unreported home mortgage interest	5,940	18,043,825	6,296	17,628,247
Unreported points	18,254	5,619,416	22,619	7,701,339
Qualified mortage insurance premiums	11,577	12,656,499	17,371	21,264,234
Investment interest	9,061	49,397,642	8,395	31,368,971
Contributions by cash or check	171,569	434,698,282	169,596	424,565,892
Contributions other than cash or check	70,403	61,442,501	70,044	59,713,638
Carryover of contributions from previous years	2,567	34,852,686	2,750	26,683,941
Child and dependent care expenses	769	1,382,178	889	1,600,514
Casualty and theft losses	393	5,565,994	341	6,906,415
Business Expenses				
Unreimbursed employee business expenses*	57,683	187,311,818	56,602	169,613,660
Other business expenses*	142,412	113,984,827	142,920	102,707,081
Total business expenses*	160,914	301,296,645	161,528	272,320,741
Net deductible unreimbursed business expenses	56,879	213,814,844	57,450	191,103,224
Political contributions	11,307	1,062,633	7,052	643,598
All other miscellaneous deductions not subject to 2% floor	2,396	7,969,789	2,175	17,170,824
Gambling losses	1,250	10,936,343	1,169	10,915,626
Total itemized deductions	304,346	4,088,399,236	308,304	4,072,251,370
Unallowed itemized deductions (due to income over threshold)	22,128	23,169,551	18,039	19,210,187
Allowable itemized deductions	304,346	4,065,229,685	308,304	4,053,041,183
Standard deductions	210,558	749,417,878	200,130	697,489,190
Total deductions	531,358	4,814,647,563	523,618	4,750,530,373

* Indented items either are part of another line or include another line. They are not part of the total.
**For 2008, deductible sales tax was reported on the income tax line. It was given its own line for 2009.

Additionally, as shown in the above table 210,558 and 200,130 full-year resident taxpayers took the standard deduction in tax years 2008 and 2009, respectively. Pursuant to § 15-30-2132, MCA, the minimum standard deduction is the greater of $1,580 (plus a statutory adjustment for inflation) or 20% of AGI and the maximum standard deduction is $3,560 (plus a statutory adjustment for inflation). Taking the inflation factor[31] into account, the maximum standard deduction was $ 4,010, $3,950, and $3,990 for tax years 2008, 2009, and 2010, respectively.

[31] Pursuant to § 15-30-2101, MCA, inflation factor "means a number determined for each tax year by dividing the consumer price index for June of the tax year by the consumer price index for June 2005."

iv. Step 4: Montana Personal Exemptions

Similar to the federal income tax, Montana allows taxpayers to claim personal exemptions.[32] Pursuant to § 15-30-2114, MCA, the personal exemption is adjusted for inflation and is calculated by multiplying the dollar amount of the exemption by the number of exemptions (*i.e.*, taxpayer, spouse, children, dependents, additional exemption for age 65 and above, additional exemption for blind). Taking the inflation factor into account, each personal exemption was $2,140, $2,110, and $2,130 for tax years 2008, 2009, and 2010, respectively.

v. Step 5: Calculate Montana Taxable Income

Pursuant to § 15-30-2101, MCA, Montana taxable income "means the adjusted gross income of a taxpayer less the deductions and exemptions provided for" under the Montana tax code. As such, taxable income is calculated using Montana AGI, the higher of itemized deductions or the standard deduction, and allowable personal exemptions.

vi. Step 6: Montana Tax Calculation.

Montana uses a single rate structure for all taxpayers, regardless of filing status.[33] The rate structure is modified by the DOR on a yearly basis by the inflation factor for the tax year, as rounded to the nearest $100.[34] Montana's rate structure is progressive, since taxpayers with higher incomes pay a higher percentage of their income in tax. However, unlike the federal brackets Montana's rates max out at a fairly low level of taxable income. The easiest way to calculate total Montana tax is to use the tax tables published by the DOR. These tables have already taken into account the progressive rates of tax and the inflation factor. Montana's tax tables for tax years 2008 through 2011 are as follows:

Tax Year 2008:

Rate Table				
If your taxable income is				
More than	But not more than	Then your tax is		Less
$0	$2,600	1%	of taxable income	
$2,600	$4,600	2%	of taxable income	$26
$4,600	$7,000	3%	of taxable income	$72
$7,000	$9,500	4%	of taxable income	$142
$9,500	$12,200	5%	of taxable income	$237
$12,200	$15,600	6%	of taxable income	$359
More than $15,600		6.9%	of taxable income	$499

[32] I.R.C. § 151; § 15-30-2114, MCA.
[33] *See* § 15-30-2103, MCA.
[34] *Id.* Montana's inflation factor was enacted by initiative in 1980. Sec. 2, I.M. No. 86, approved Nov. 4, 1980.

Tax Year 2009:

Rate Table				
If your taxable income is				
More than	But not more than	Then your tax is		Less
$0	$2,600	1%	of taxable income	
$2,600	$4,500	2%	of taxable income	$26
$4,500	$6,900	3%	of taxable income	$71
$6,900	$9,300	4%	of taxable income	$140
$9,300	$12,000	5%	of taxable income	$233
$12,000	$15,400	6%	of taxable income	$353
	More than $15,400	6.9%	of taxable income	$492

Tax Year 2010:

Rate Table				
If your taxable income is				
More than	But not more than	Then your tax is		Less
$0	$2,600	1%	of taxable income	
$2,600	$4,600	2%	of taxable income	$26
$4,600	$6,900	3%	of taxable income	$72
$6,900	$9,400	4%	of taxable income	$141
$9,400	$12,100	5%	of taxable income	$235
$12,100	$15,600	6%	of taxable income	$356
	More than $15,600	6.9%	of taxable income	$496

Tax Year 2011:

Rate Table				
If your taxable income is				
More than	But not more than	Then your tax is		Less
$0	$2,700	1%	of taxable income	
$2,700	$4,700	2%	of taxable income	$27
$4,700	$7,200	3%	of taxable income	$74
$7,200	$9,700	4%	of taxable income	$146
$9,700	$12,500	5%	of taxable income	$243
$12,500	$16,000	6%	of taxable income	$368
	More than $16,000	6.9%	of taxable income	$512

A more detailed discussion of brackets and filing status is presented in section 3 of this paper.

vii. Step 7: Montana Tax Credits

Similar to federal income taxes, the final computation deals with applying Montana tax credits and payments made through withholdings or estimated payments toward the tax in order to determine the size of the refund or the amount of money due. In some situations a tax credit can reduce tax dollar for dollar. Also, unlike deductions, when Congress adds another federal tax credit it does not generally appear automatically as a credit for Montana individual income tax purposes.

Tax credits can be separated into three categories: nonrefundable credits with no carryover, nonrefundable credits with a carryover, and refundable credits. When a credit is nonrefundable, a taxpayer can only offset tax liability with the credit. In the event tax liability is less than the amount of the credit, a refund will not be issued and the taxpayer cannot reduce tax liability below zero. However, if a nonrefundable credit has a carryover provision the taxpayer may be able to utilize the remaining portion of the credit in another tax year. Moreover, if a tax credit is refundable the taxpayer may actually receive a refund in situations where tax liability is less than the amount of the credit.

a. Nonrefundable Credits with No Carryover

(1) Capital gains credit (*see* § 15-30-2301, MCA, and Biennial Report, p. 231, table 4.1)
(2) Credit for an income tax liability paid to another state or country (*see* §§ 15-30-2104 and 15-30-2302, MCA, and Biennial Report, p. 251, table 4.29);
(3) College contribution credit (*see* § 15-30-2326, MCA, and Biennial Report, p. 232, table 4.2);
(4) Qualified endowment credit (*see* §§ 15-30-2327 through 15-30-2329, MCA, and Biennial Report, p. 233, table 4.3);
(5) Energy conservation installation credit (*see* §§ 15-30-2319 and 15-32-109, MCA, and Biennial Report, p. 234, table 4.4);
(6) Alternative fuel credit (*see* § 15-30-2320, MCA, and Biennial Report, p. 234, table 4.5);
(7) Rural physician's credit (*see* §§ 15-30-2369 through 15-30-2372, MCA, and Biennial Report, p. 235, table 4.6);
(8) Health insurance for uninsured Montanans credit (*see* §§ 15-30-2367 and 15-31-132, MCA, and Biennial Report, p. 236, table 4.7);
(9) Elderly care credit (*see* § 15-30-2366, MCA, and Biennial Report, p. 237, table 4.8); and
(10) Recycle credit (*see* §§ 15-32-601 through 15-32-611, MCA, and Biennial Report, p. 238, table 4.10).

b. Nonrefundable Credits with a Carryover

(1) Oilseed crushing and biodiesel/biolubricant production facility credit (*see* § 15-32-701, MCA, and Biennial Report, p. 239, table 4.11);

(2) Biodiesel blending and storage credit (*see* § 15-32-703, MCA, and Biennial Report, p. 240, table 4.12);
(3) Contractor's gross receipts tax credit (*see* § 15-50-207, MCA, and Biennial Report, p. 257, table 6.2);
(4) Geothermal systems credit (*see* § 15-32-115, MCA, and Biennial Report, p. 240, table 4.13);
(5) Alternative energy systems credit (*see* §§ 15-32-201 through 15-32-203, MCA, and Biennial Report, p. 241, table 4.14);
(6) Alternative energy production credit (*see* §§ 15-32-401 through 15-32-407, MCA, and Biennial Report, p. 242, table 4.15);
(7) Dependent care assistance credit (*see* §§ 15-30-2365, 15-30-2373, 15-31-131, and 15-31-133, MCA and Biennial Report, p. 243, table 4.16);
(8) Historic property preservation credit (*see* §§ 15-30-2342 and 15-31-151, MCA, and Biennial Report, p. 244, table 4.17);
(9) Infrastructure users fee credit (*see* § 17-6-316, MCA, and Biennial Report, p. 245, table 4.19);
(10) Empowerment zone credit – expired from tax year 2011forward (*see* §§ 15-30-2356 and 15-31-134, MCA, and Biennial Report, p. 246, table 4.20);
(11) Increasing research activities credit (*see* §§ 15-30-2358, 15-31-150, MCA, and Biennial Report, p. 246, table 4.21);
(12) Mineral and coal exploration incentive credit (*see* §§ 15-32-501 through 15-32-510 MCA, and Biennial Report, p. 247, table 4.22);
(13) Film employment production credit – this credit can be carried forward or refunded (*see* §§ 15-31-901 through 15-31-911, MCA, and Biennial Report, pp. 247-248, tables 4.23 and 4.24);
(14) Adoption credit (*see* § 15-30-2364, MCA, and Biennial Report, p. 250, table 4.27).

c. Refundable credits

(1) Elderly homeowner/renter credit (*see* §§ 15-30-2337 through 15-30-2341, MCA, and Biennial Report, p. 250, table 4.28);
(2) Film employment production credit – this credit can be carried forward or refunded (*see* §§ 15-31-901 through 15-31-911, MCA, and Biennial Report, pp. 247-248, tables 4.23 and 4.24);
(3) Film qualified expenditures credit (*see* §§ 15-31-901 through 15-31-911, MCA, and Biennial Report, p. 248, table 4.25);
(4) Insure Montana small business health insurance credit (*see* §§ 15-30-2368, 15-31-130, and 33-22-2006, MCA, and Biennial Report, p. 249, table 4.26);
(5) Temporary Emergency Lodging credit (*see* §§ 15-30-2381 and 50-51-114, MCA, and Biennial Report, p. 252, table 4.30);

d. The Bottom Line – Fiscal Impact of Montana Tax Credits

Some Montana tax credits are used frequently while other credits are not as popular. The following charts from the Biennial Report (pp. 61 and 231) shed light on how often credits are used and their corresponding impact on the general fund.

Capital Gains Credit (Table 4.1)

	Residents		Non-Residents		Part-Year Residents		Total	
	N	$	N	$	N	$	N	$
2005	53,187	$15,440,738	9,799	$3,942,692	2,418	$443,246	65,404	$19,826,676
2006	61,392	$19,599,422	10,474	$2,931,577	2,575	$419,008	74,441	$22,950,007
2007	68,967	$40,025,383	10,329	$3,358,241	2,779	$752,115	82,075	$44,135,739
2008	41,242	$26,151,925	8,031	$8,609,630	1,442	$457,981	50,715	$35,219,536
2009	24,961	$17,974,296	5,346	$1,918,020	766	$175,272	31,073	$20,067,588

Montana Individual Income Tax Credits Reported on Full-Year Residents' Returns 2008 and 2009

	2008		2009	
	Count	Total	Count	Total
Credits				
Non-Refundable and No Carryover				
Other states' income tax credit	10,735	20,931,634	9,765	16,975,208
College contribution tax credit	2,767	225,228	2,820	237,180
Qualified endowment tax credit	617	1,919,025	579	1,746,260
Energy conservation tax credit	23,656	7,853,727	28,594	9,998,955
Alternative fuel tax credit	45	27,402	55	38,175
Rural physician's tax credit	35	160,294	20	90,312
Insurance for uninsured Montanans credit	493	413,966	377	294,402
Elderly care tax credit	46	48,026	42	45,059
Recycling tax credit	77	527,908	85	439,254
Oil seed crushing/biodiesel facility credit	<10	4,047	0	0
Biodiesel blending/storage tank credit	<10	1,090	<10	2,630
Non-Refundable but with Carryover				
Contractor's gross receipts tax credit	463	1,738,387	510	2,676,113
Geothermal systems tax credit	156	215,157	302	525,153
Alternative energy systems credit	1,804	997,615	2,321	1,302,796
Alternative energy production tax credit	<10	8,315	15	33,086
Dependent care assistance credit	<10	24,116	<10	7,769
Historic property preservation tax credit	18	60,116	23	134,543
Infrastructure user fee credit	16	30,372	12	27,699
Empowerment zone credit	0	0	0	0
Research activities tax credit	12	391,790	17	345,813
Mineral exploration tax credit	<10	44,530	<10	7,749
Film production employment tax credit	0	0	0	0
Adoption credit	205	186,069	194	165,300
Total Non-Refundable Credits	39,108	35,808,814	43,357	35,093,456
Refundable Credits				
Elderly homeowner/renter tax credit*	16,698	8,252,383	17,053	8,465,090
Film production employment tax credit	0	0	0	0
Film qualified expenditure tax credit	<10	29,230	<10	19,047
Insure Montana small business health insurance credit	792	2,380,374	911	2,513,344
Emergency lodging credit	<10	396	0	0
Total Refundable Credits	13,806	8,901,758	14,497	9,311,534
Total Credits	69,252	66,387,531	75,430	63,883,305

* Credits claimed on tax returns. See the Property Tax section for credits claimed with no income tax return.

3. TAX BRACKETS, RATES, AND FILING OPTIONS: AN OVERVIEW OF THE FEDERAL SYSTEM

A basic understanding of federal filing options of the past and present is helpful when evaluating policy issues. Consequently, this section provides an overview of the history behind federal income tax filing options and the existing federal structure. It is not a comprehensive review of the federal filing system, as numerous articles have been written on this topic.[35] Section 4 of this paper then covers Montana's history regarding income tax filing options for married taxpayers, which includes an analysis of when Montana taxpayers started to file separately on the same form.

The original 1913 federal tax form was primarily designed for individuals, as opposed to married couples. The instructions stated that a "return shall be made by every citizen of the United States".[36] And while a "joint return" was an option for married individuals, there was no tax advantage to filing one. In fact, the early instructions during this era cautioned that when spouses each had separate income they "should make a separate return".[37] This advice was especially true for high-income taxpayers that were subject to highly progressive surtaxes. In 1918, these rates started at 1% for individuals with $6,000 in net income to 65% for those with incomes above $1,000,000.[38]

i. 1930 – 1947: Community Property vs. Noncommunity Property States and the Assignment of Income Problem

The highly progressive surtax of the federal system encouraged high-income taxpayers to look for ways to lower their federal tax liabilities through income splitting. That is, if they could each take a bite at the tax rate table, they would ultimately be subject to less tax. In community property states it was common for taxpayers to claim that the income of the community (*i.e.*, the husband and the wife) was equally owned by each spouse, and separate returns were filed using this theory.[39] Additionally, in noncommunity property states couples tried to shift income from one spouse to the other through contracts that were enforceable under state law.[40] These arrangements opened the floodgates of

[35] *See, e.g.,* Patricia A. Cain, Symposium, *Taxing Families Fairly,* 48 SANTA CLARA L. REV. 805 (2008); Wendy Richards, Comment, *An Analysis of Recent Tax Reforms from a Marital-Bias Perspective: It is Time to Oust Marriage from the Tax Code*, 2008 WIS. L. REV. 611 (2008); Lora Cicconi, Comment, *Competing Goals Amidst the "Opt-Out" Revolution: An Examination of Gender-Based Tax Reform in Light of New Data on Female Labor Supply,* 42 GONZ. L. REV. 257 (2006); Stephen W. Mazza & Tracy A. Kaye, *Restricting the Legislative Power to Tax in the United States,* 54 AM. J. COMP. L. 641 (Supp. 2006); Shari Motro, *A New "I Do": Towards a Marriage-Neutral Income Tax*, 91 IOWA L. REV. 1509 (2006); Ann F. Thomas, Symposium 1999 Part One: *Marriage and the Income Tax Yesterday, Today, and Tomorrow: A Primer and Legislative Scorecard,* 16 N.Y.L. SCH. J. HUM. RTS. 1 (1999); Amy C. Christian, *The Joint Return Rate Structure: Identifying and Addressing the Gendered Nature of the Tax Law,* 13 J. L. & POLITICS 241 (1997); Richard B. Malamud, *Allocation of the Joint Return Marriage Penalty and Bonus,* 15 VA. TAX REV. 489 (1996).
[36] United States Internal Revenue, *1913 Form 1040*, at 4 (instructions).
[37] United States Internal Revenue, *1918 Form 1040*, at 3 (instructions).
[38] *Id.* at 3 (table and instructions for calculation of surtax).
[39] Cain, *supra* note 35, at 809.
[40] *See id.* at 815.

litigation between the Collector of Internal Revenue (IRS) and individual taxpayers. Eventually the United States Supreme Court had an opportunity to weigh in on income splitting in what are now two very famous federal income tax cases.

In the 1930 case of *Lucas v. Earl,* a married couple agreed to share all of their income jointly.[41] The agreement was enforceable under state law, and one spouse could demand payment from the other. As such, the couple filed separate returns and took advantage of the progressive rate structure. The IRS disagreed with this arrangement, and in a short unanimous opinion Justice Holmes determined that the assignor of income was liable for tax on the assigned earnings.[42] Holmes famously stated that this essentially attributed fruits to "a different tree from that on which they grew."[43] The *Lucas* case is frequently cited by courts when one individual attempts to assign income to another individual.[44]

In the 1930 case of *Poe v. Seaborn,* a married couple from a community property state (Washington) split the community income 50/50, and each spouse filed separate returns.[45] Unlike *Lucas v. Earl,* the U.S. Supreme Court held that it was appropriate for the husband and wife to each claim one-half of the community income from the property.[46] The Court ruled this way because each spouse had a vested interest in the other spouse's wages under state law, and the earnings of the spouses belonged to the community as a whole.[47]

In 1937, President Roosevelt addressed Congress concerning revenue loss from community property states.[48] In response, the U.S. Treasury proposed that all married individuals should file a joint return that uses the same tax rate schedule as a single person.[49] The proposal would have increased taxes on married couples and was therefore defeated on moral grounds.[50] Interestingly, six states became temporary community property states during this timeframe in order to take advantage of the federal tax rate structure.

ii. 1948-1951: Major Change to the Rate Schedule to Encourage Joint Returns and the Addition of Head of Household Rates

In 1948, Congress decided to deal with the community property problem by encouraging married individuals to file a joint return.[51] If spouses decided to aggregate income and

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[41] *Lucas v. Earl,* 281 U.S. 111, 113-114 (1930).
[42] *Id.* at 114-115.
[43] *Id.* at 115; Motro, *supra* note 35, at 1517.
[44] *See, e.g., Commissioner v. Banks,* 543 U.S. 426, 433 (2005); *Sparkman v. Commissioner,* 509 F.3d 1149, 1157 (9th Cir. 2007).
[45] *Poe v. Seaborn,* 282 U.S. 101, 108-109 (1930).
[46] *Id.* at 118.
[47] *Id.* at 117.
[48] Cain, *supra* note 35, at 816.
[49] *Id.*
[50] *Id.* (citing Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1391 (1975)).
[51] *Id.* at 817.

losses, they were allowed to take advantage of tax rates that were twice as wide as those of a single person.[52] This effectively gave the citizens of the several states the ability to pay the same amount of tax, regardless of state community property law. For example, according to the [1948 federal tax table](), a married couple with no dependents and $5,000 of taxable income would pay $544 in tax using a joint return.[53] Likewise, if the husband and wife each had $2,500 in income and they both filed separate returns, they would each face $272 in tax (*i.e.,* exactly one-half of a married filing jointly return). Using the same example, this hypothetical couple would have paid $689 in tax on a joint 1947 return (*i.e.,* before the change in the law), while paying $330 each by filing separate 1947 returns.[54] In other words, the couple saved $29 in 1947 by filing separate returns, prior to the change in the law.

In 1952, another rate table was introduced into the federal system entitled "head of a household".[55] The new rate table was designed in response to arguments from single-parent taxpayers that they should be allowed more tax benefits when they provided a home for dependents.[56] The special rate entitled qualified single taxpayers to obtain better tax treatment than a single person, but less favorable treatment than a couple using the married filing jointly rate structure.

iii. 1968: Single Taxpayers Complain About Rate Structure and the Creation of the "Marriage Tax Penalty"

Congress eventually faced complaints from single individuals who claimed that it was unfair to give married individuals rate structures that were twice as wide as those for single individuals.[57] This claim was made on the theory that single individuals had a higher proportional cost of living based on "economies of scale" and the fact that they were not taxed on the imputed income of spouses who stayed home providing household services.[58] For example, if both a single and a married individual could rent an apartment for $500 per month, the single person's effective cost would be $500 per month while the married individual's effective cost would be $250 (*i.e.,* 50%). Moreover, if one married spouse obtained income from a job while the other spouse performed household services at home, the married couple arguably received both the benefit of a lower tax rate and the benefit of not having to pay someone to perform household repairs, care for children, cook meals, wash clothes, and clean the house. This type of arrangement can be referred to as a "marriage tax bonus."

In 1969, Congress responded to this issue by changing the rate table for married individuals "so that single taxpayers would never pay more than 120% what a married

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[52] *Id.*
[53] United States Internal Revenue, *1948 Form 1040*, at 4 (tax table).
[54] United States Internal Revenue, *1947 Form 1040*, at 4 (tax table).
[55] United States Internal Revenue, *1952 Form 1040*, at 4 (tax table).
[56] Cain, *supra* note 35, at 818-819 (2008); *see also* 26 U.S.C. §§1(b), 2(b) (2000) (defining head of household and providing the rates).
[57] Cain, *supra* note 35, at 818.
[58] *Id.*

couple would pay on the same amount of income."[59] However, the new rate tables did not end the debate, and economists pointed out that a "marriage tax penalty" was now being imposed on married spouses who decided to re-enter the workforce, which in turn reduced the economic effect of their labor.[60] For example, if a husband was making $50,000 a year, he would be in a higher tax bracket and a wife who decided to enter the workforce would be taxed at this higher bracket, as opposed to the lower bracket that could be obtained through separate filing.

iv. 2001: Congress Revises Rate Table to Mitigate the "Marriage Tax Penalty"

In 2001, Congress attempted to mitigate the marriage tax penalty by making the rate brackets twice as wide for married individuals as for single individuals.[61] However, the rate brackets were not designed to be twice as wide for all levels of income. Instead, the rate brackets started to shrink between the 25% and 28% brackets.[62] Essentially, this made a hybrid rate structure between the rate structure of 1969 that favored single taxpayers, and the rate structure of 1948 that favored married individuals.[63] Married individuals with lower levels of income received the marriage tax bonus, while married individuals with higher levels of income were subjected to the marriage tax penalty.

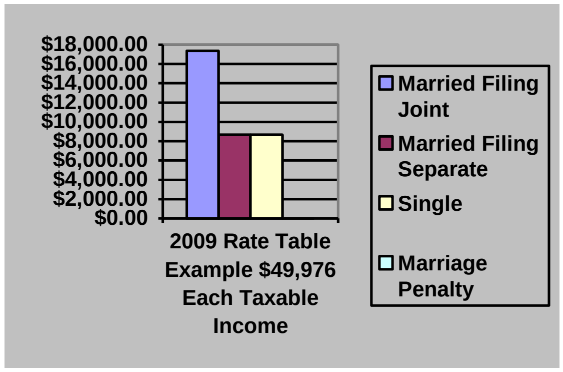
v. 2009: Modern Federal Rate Structure: Examples and Statistics

Pursuant to the 2009 federal rate table, the marriage tax penalty kicks in when married individuals filing separate returns have over $68,525 in taxable income or when a married couple earns over $137,050 in taxable income and files a joint return.[64] Before this point, an individual filing a single return and an individual filing a married filing separate return faced the same rate of tax.

A. Modern Example of How Married Individuals and Single Individuals Pay the Same at Lower Levels of Income

If we assume that a husband and wife each make $49,976 in taxable income (*i.e,* $99,952 joint), the couple has a tax liability of $17,369 if they file jointly and $17,362 (*i.e.*, $8,681 each) if they file separately. Additionally, a single taxpayer with $49,976 in taxable income has a tax liability of $8,681, which is the same amount as a married taxpayer who files separately.

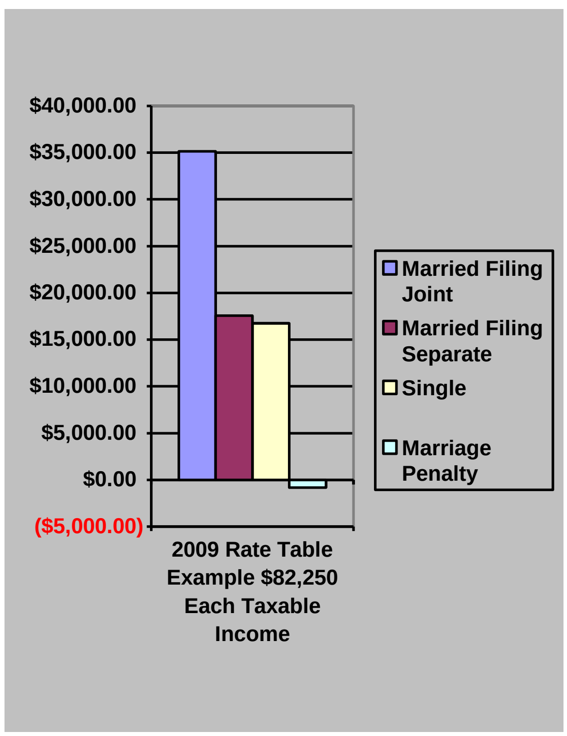
[59] Cain, *supra* note 35, at 818; Motro, *supra* note 35, at 1531.
[60] Thomas, *supra* note 35, at 54.
[61] Motro, *supra* note 35, at 1532, 1566.
[62] *Id.* at 1566.
[63] *Id.*
[64] Department of the Treasury, Internal Revenue Service, *1040: Instructions 2009*, at 101 (Tax Rate Schedules).



SOURCE: Department of the Treasury, Internal Revenue Service, *1040: Instructions 2009*, at 82, 88 (Tax Tables).

B. *Modern Example of How Married Couples Pay More When Income Increases*

If we assume that a husband and wife each make $82,250 in taxable income (*i.e.*, $164,500 joint), the couple has a tax liability of $35,136 if they file jointly and $17,568 each if they file separately. Additionally, a single taxpayer with $82,250 in taxable income has a tax liability of $16,750, which is $818 less than a married taxpayer who files separately. Consequently, it can be argued that an $818 marriage tax penalty exists in this example.

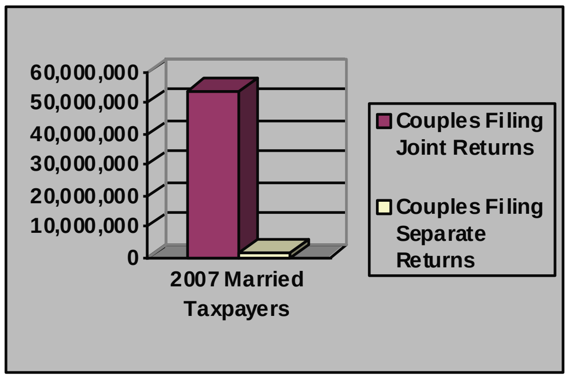


SOURCE: *See* Department of the Treasury, Internal Revenue Service, *1040: Instructions 2009*, at 101 (Applying Tax Rate Schedules).

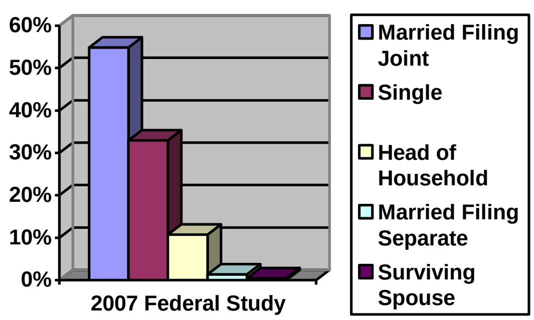
C. 2007 Federal Filing Statistics

In 2007, 54,065,030 returns were filed by married persons filing jointly, while only 2,730,935 (*i.e.*, 1,365,468 couples) returns were filed by married persons filing separately.[65] Consequently, less than 3% of couples decided to use the married filing separately rate table. Additionally, 21,169,039 head of household returns were filed, while 64,926,879 single taxpayer returns were filed and 86,923 surviving spouse returns were filed. Statistically, these findings can be reported as follows:

Less Than 3% of Married Couples File Separate Federal Returns[66]



Percentage of Individual Taxpayers Using the Federal Rate Structures[67]



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[65] Internal Revenue Service, Statistics and Income Division, *Tax Statistics: Table 1.2 All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2007, available at:* http://www.irs.gov/pub/irs-soi/07in12ms.xls.

[66] *See id.*

[67] *See id.*

4. MONTANA'S HISTORY OF INDIVIDUAL INCOME TAX FILING OPTIONS, INCLUDING AN ANALYSIS OF THE RATIONALE FOR ALLOWING MARRIED TAXPAYERS TO FILE SEPARATELY ON THE SAME FORM

This section provides an overview of important statutory changes in Montana law regarding filing options. Additionally, it summarizes the results from two interim committee studies in which changes to the Montana filing system were contemplated. Interestingly, the ability to file separately on the same form was implemented by the Department of Revenue (DOR) in 1972 because it was difficult to obtain and compare two married filing separate returns for one couple during an audit or review. This section concludes with an overview of Montana's current rate structure and some of the filing pitfalls for married taxpayers.

i. 1933: Enactment of Montana Income Tax

Similar to the federal return during this timeframe, a joint return was technically an option, but it provided no monetary advantage other than the fact that a person could potentially pay less in tax preparation fees by filing jointly. Indeed, there was only one tax rate table for both married and single taxpayers. The rate table imposed a 1% tax on the first $2,000 of net income, a 2% tax on the second $2,000, a 3% tax on the third $2,000, and a 4% tax on everything above $6,000.[68] Hence, if a husband and wife earned $2,000 each, they could save $20 by doing separate returns.[69] Interestingly, in order to file a tax return, a person had to pay a $1 filing fee to the State Board of Equalization (Board).[70]

ii. 1957: More People Required to File a Return

The tax return filing requirement stayed static until 1957, at which point a law made it harder to escape the filing obligation. A single person (or married but not living with or supporting a husband, wife, or family) was entitled to earn $599.99 net income before a return was required, while a married person who was living with the other spouse was entitled to earn $1,199.99 net income.[71] Moreover, the rate table became more progressive.[72]

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[68] Sec. 2, Ch. 181, L. 1933.
[69] The $20 savings was calculated as follows: If the married individuals filed jointly the first $2,000 in net income (after exemptions) would produce a $20 tax, while the second $2,000 would produce a $40 tax, for a combined total of $60. Yet, if the married individuals filed separate returns they would each pay $20 in tax, for a grand total of $40.
[70] Sec. 19, Ch. 181, L. 1933.
[71] Sec. 2, Ch. 227, L. 1957.
[72] A 1% tax was imposed on the first $1,000 of income, a 1.5% tax on the second $1,000, a 2% tax on the third $1,000, a 2.5% tax on the fourth $1,000, a 3% tax on the fifth $1,000, a 3.5% tax on the sixth $1,000, a 4% tax on the seventh $1,000, and a 5% tax on everything above $7,000. Sec. 2, Ch. 228, L. 1957.

Unlike the 1933 statute, the joint return was not listed as an option but the Board was given the power by the Legislature to create forms and instructions.[73] It is therefore difficult to know whether the Board adopted a joint return, but it would still be more advantageous to file married filing separately.

iii. 1963: The Joint Income Tax Return Is Provided for by Statute

In 1963, Senate Bill No. 102, which provided for the election of filing joint returns, easily passed the Senate and the House without a single negative vote. [74] The bill contained a provision that read:

> (2) In accordance with instructions set forth by the board, every taxpayer who is married and living with husband or wife and is required to file a return may, at his or her option, file a joint return with husband or wife even though one of the spouses has neither gross income nor deductions. If a joint return is made, the tax shall be computed on the aggregate taxable income and the liability with respect to the tax shall be joint and several.[75]

A review of the Senate Taxation Committee minutes does not shed light on the reasoning behind the bill.[76] However, the minutes of the House Ways and Means Committee show more. Specifically, the chairman of the Board testified that "many of the changes in [the] bill do not change the effect of the existing provisions." Additionally, the chairman indicated the purpose was to "expressly provid[e] for the filing of joint returns by husband and wife and to provide that the tax liability is joint and several".[77] It is therefore plausible that a joint return was implicitly allowable from 1957 through 1963. However, since there was only one tax rate table it was generally more advantageous to file separate returns in a two-income household. Moreover, due to the 1963 change in the law, both spouses faced tax liabilities if a joint return was filed, even if the error or omission was caused by the other spouse.

iv. 1966 - 1972: Montana Legislative Council Report on Montana Taxation and the Start of Married Filing Separately on the Same Form

In 1966, the Legislative Council (Council) undertook a major study of the existing tax structure in Montana. The study created numerous staff reports, in addition to a 91-page Report entitled *Montana Taxation*.[78] While individual income tax was only a small piece

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[73] Sec. 1, Ch. 227, L. 1957.
[74] Senate Journal, 38th Sess., p. 175 (MT 1963); House Journal, 38th Sess., p. 571 (MT 1963).
[75] Sec. 1, Ch. 201, L. 1963.
[76] Minutes of the Senate Taxation Committee, p. 1 (12:00 p.m. Jan. 24, 1963). The minutes state that Senate Bill No. 102 "was also discussed by Senator Brenner, the author of the bill." The nature of the discussion is not contained in the minutes, but a "Do Pass" motion carried unanimously.
[77] Minutes of the House Ways and Means Committee, pp. 1-2 (9:00 a.m. Feb. 27, 1963).
[78] *Montana Taxation, A Report to the Fortieth Legislative Assembly*, Montana Legislative Council, Report No. 23 (Dec. 1966).

of the study, the Council addressed the fact that Montana encourages married filing separately. The report states:

> The Montana tax rates vary from 1.1 percent of the first $1,000 of taxable income to 7.9 percent of income over $7,000. Although the federal tax allows married couples to file joint returns and take advantage of tax brackets twice as wide as single taxpayers, Montana law allows no such provision. Montana law allows separate filing of wife and husband if they both earn income.[79]

Additionally, the report made the following recommendation:

> Currently, if a wife earns income, she may file a return separate from her husband. There is a major problem in auditing these returns. The two returns must be together to properly audit them and this is difficult to accomplish. Taxpayers are never sure how to allocate income, deductions and exemptions between returns. Also, there are a large number of taxpayers, especially in low income groups, who unknowingly do not take advantage of filing separate returns.
>
> There are two main alternatives for solution to these problems: (1) make some provision for income splitting; or (2) eliminate the provision allowing separate filing in our income tax law. The Task Force recommends that the provision for separate filing be eliminated. The additional revenue forthcoming from this change would be about $3 to $5 million per year.[80]

Based on the Council report, it is clear that married filing separately was very common. However, it is also clear that the Board had not created a form that allowed married couples to file separately on the same form.

v. 1973 – 1976: The Department of Revenue and the 1976 Subcommittee on Taxation Study

"Following the adoption of the new Montana Constitution in 1972, the Forty-Third Legislative Assembly abolished the three member State Board of Equalization and established a reorganized State Department of Revenue."[81] As such, in 1973 the Legislature changed all statutory references from the Board to the DOR.[82]

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[79] *Id.* at 47.
[80] *Id.* at 76-77.
[81] *Report of the State Department of Revenue to the Governor and Members of the Forty-fourth Legislative Assembly of the State of Montana for the Period July 1, 1972 to June 30, 1974*, William A. Groff, Acting Director, p. 1 (1974).
[82] *See* Secs. 1 – 256, Ch. 516, L. 1973.

A review of the DOR's historical tax records confirmed that the modern tax return that allows a husband and wife to file separately on the same form did not come into existence until 1972.[83] The adoption of this form did not require a change in substantive law, but it was a very popular option. [84] Presumably, this change made it much easier to audit returns.

In 1976, the Subcommittee on Taxation undertook a study to investigate the gross income tax, in addition to studying the "'income-splitting' problem - - the effects of Montana's single set of rates and incentive to file separately upon married taxpayers with one source of income".[85] A meeting was held on April 23, 1976, and the DOR was asked "to draw up alternative sets of rate tables which would favor joint husband-wife returns."[86] The subcommittee deliberations on this issue were summarized as follows in the report:

> The second major area which the subcommittee was directed to consider was income-splitting between husband and wife. Unlike the Internal Revenue Code with its four sets of rates (married-joint, married-filing separately, single-head of household, and single), the state income tax has but one set of rates for all taxpayers. Since the tax bill on $20,000 of taxable income is $1,439, while the bill for $10,000 taxable income is $539, a husband and wife who each earn $10,000 taxable income will always file separate state returns -- they save $407 over what they would owe on a joint return on $20,000.
>
> ….
>
> The subcommittee requested the department of revenue to draw up sets of rate schedules to make filing the joint return more advantageous for married taxpayers. The department went through five sets and found that one or another of the following problems always appeared:
>
> (1) If we keep single taxpayers' liability where it is now and cut the married-filing-jointly rate until it is advantageous for nearly all couples, the revenue loss to the state is too large ($8 million to $11 million per year);
>
> (2) If we design an advantageous joint rate within the limits of a modest revenue loss ($3 million to $4 million), the taxes of single persons generally have to go up;

[83] The first sentence in the instructions for the 1972 Montana Individual Income Tax Return provides: "The 1972 return form has been redesigned to permit husbands and wives who desire to file separately to do so using only one return form."

[84] A 1976 interim study by the Subcommittee on Taxation shows that out of 118,714 married filing separate returns, 112,676 were married filing separate on the same form, 3,691 were separate on different forms, and 2,347 were separate with one spouse not filing. *See* *Montana's State Income Tax, A Report to the Forty-Fifth Legislature*, Interim Study by the Subcommittee on Taxation, App. B (Dec. 1976).

[85] *Id.* at 3.

[86] *Id.* at 5.

(3) If we go to simple income-splitting for joint returns relative to single returns, the rate differential, like the federal rates from 1948 to 1971, discriminates against single persons;

(4) If we follow the rate relationships of the current federal tables, where the second table sets significantly higher rates for marrieds-filling-separately (with rates for singles falling in between), and avoid the major revenue loss, taxes will go up for many married taxpayers in Montana with separate incomes.

In short, there appears to be no way to move from where we are to another position without either increasing taxes on some groups or incurring substantial revenue loss. The subcommittee therefore makes no recommendation for adopting a joint return rate schedule. [87]

vi. 1983 – 1985: Married Filing Separately on the Same Form Recognized in Statute for Child and Dependent Care Expenses

In 1983, House Bill No. 125 sought to eliminate the requirement that a joint income tax return must be filed by a married individual when claiming a deduction for child and dependent care expenses.[88] The minutes of the House Taxation Committee show that no one opposed the bill, while proponents testified that the bill would correct a marriage penalty problem.[89] That is, Montana families with both parents working were not filing joint returns to claim child care expenses due to the fact that the rate of tax went up with a joint return. The Director of the DOR stated that the agency's concern with the bill was from "an administrative point of view."[90] The Director suggested that language should be inserted stating "if separate filing taxpayers are allowed this deduction, they must file separately on the same form."[91] An amendment was made to the bill that contained the "same form" language, and it sailed through the House without any negative votes.[92] Moreover, the Senate Taxation Committee voted that the bill be concurred in, and it passed the Senate with only two negative votes.[93] The bill was signed into law by the Governor, and the ability to file married filing separately on the "same form" was officially codified in the statute at § 15-30-121(3)(b), MCA (current version at § 15-30-

[87] *Id.* at 11-12.
[88] *See* Ch. 118, L. 1983 (current version at § 15-30-2131, MCA).
[89] Minutes of the House Taxation Committee, p. 2 (8 a.m. Jan. 11, 1983).
[90] *Id.*
[91] *Id.*
[92] Minutes of the House Taxation Committee, p. 5-6 (Jan. 13, 1983); History and Final Status of Bills and Resolutions of the Senate and House of Representatives of the State of Montana, Forty-Eighth Legislature, p. 46 (1983).
[93] Minutes of the Senate Taxation Committee, p. 6 (March 4, 1983); History and Final Status of Bills and Resolutions of the Senate and House of Representatives of the State of Montana, Forty-Eighth Legislature, p. 46 (1983).

2131, MCA). Two years later the "same form" language was retained when the same statute was amended by Senate Bill No. 436, but it was not deemed a substantive change to the law, and there were no discussions concerning the additional language in the minutes.[94]

vii. 1992 Special Session: Married Filing Separately on the Same Form Recognized in Statute for Estimated Tax Payments

In the January 1992 Special Session, House Bill No. 14 sought revenue by requiring estimated individual income tax payments to be made in four installments and through employer withholdings.[95] A small part of the bill provided that the penalty for failing to withhold was computed differently for married individuals filing separately on the "same form".[96] The bill stated that when married couples file separately on the same form they must compute a "failure to properly withhold" penalty based on the combined tax liability and combined credits and withholdings.[97] This was beneficial when one spouse owed tax and the other overpaid, since the penalty was based on the unpaid tax after applying the overpayment from the other spouse. The bill was introduced on January 7, 1992, and it was signed into law by Governor Stephens on February 4, 1992.

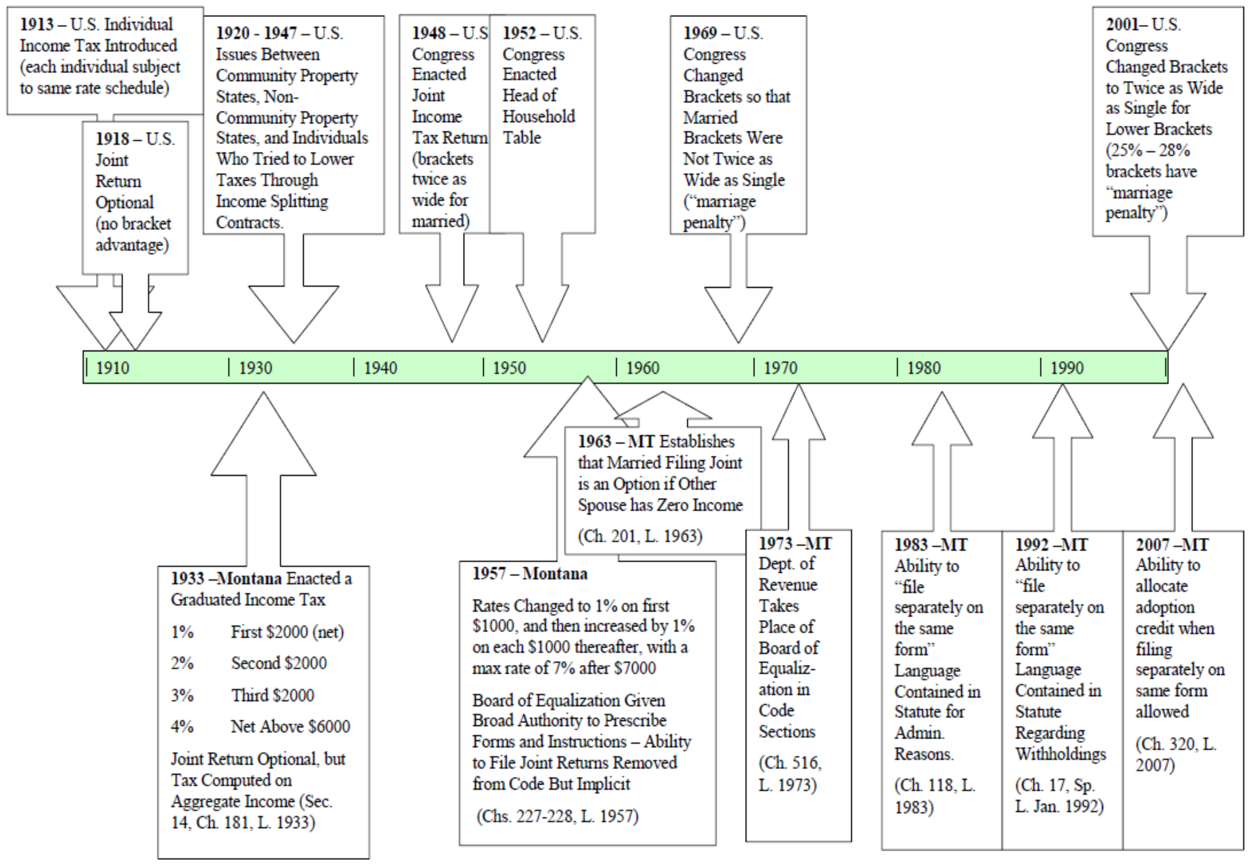
viii. 2007: Married Filing Separately on the Same Form Recognized in Statute for Adoption Tax Credit

In 2007, House Bill No. 490 was introduced to allow a tax credit equal to $1,000 for legal adoptions that occurred on or after January 1, 2007.[98] The bill initially provided that married taxpayers filing separately on the same "return" could allocate the credit between the spouses. However, this language was amended to filing separately on the same "form", as technically two returns are being filed when a married couple uses one form to file separately, as pointed out by the fiscal note.[99] There was no discussion in either the House Committee on Taxation or the Senate Committee on Taxation regarding the language change.[100] However, the purpose of the bill was to offset the fact that couples who adopted children and claimed the federal adoption tax credit actually saw an increase in Montana taxes due to the credit at the federal level. The bill easily passed the House and the Senate, and it was signed into law by Governor Schweitzer on April 28, 2007.

[94] *See* Sec. 1, Ch. 613, L. 1985 (current version at § 15-30-2131, MCA); Minutes of the Senate Taxation Committee, pp. 1-2 (Feb. 27, 1985) ("Senator Towe asked if there was a substantive change in the law. Mr. Hall [of the DOR] said, no, that the reason for the extensive changes in the bill were that formerly the Montana law had referred to federal code and that was no longer possible."); Minutes of the Senate Taxation Committee, p. 4 (Mar. 11, 1985); Minutes of the House Taxation Committee, p. 8 (Mar. 27, 1985).
[95] *See* Sec. 1, Ch. 17, Sp. L. Jan. 1992 (amending § 15-30-241, MCA (current version at § 15-30-2512, MCA)).
[96] *See id.* (amending § 15-30-241, MCA (current version at § 15-30-2512(5)(d), MCA)).
[97] *Id.*
[98] Ch. 320, L. 2007 (now codified at § 15-30-2364, MCA).
[99] *Fiscal Note 2009 Biennium: HB 490*, p. 3 (Feb. 6, 2007).
[100] Minutes of the House Committee on Taxation (Feb. 2, 2007); Minutes of the House Committee on Taxation (Feb. 9, 2007); Minutes of the Senate Committee on Taxation (Mar. 15, 2007); Minutes of the Senate Committee on Taxation (Apr. 9, 2007).

The following is a summary comparison of filing options in the federal and Montana income tax systems:

Filing Option Timeline



ix. Montana's Current Rate Structure Encourages Most Married Couples to File Separately on the Same Form

As it stands, Montana uses a single rate structure for all taxpayers, regardless of filing status.[101] The rate structure is modified by the DOR on a yearly basis by the inflation factor for the tax year, as rounded to the nearest $100.[102] Montana's income tax rates for tax year 2011 are as follows:

[101] *See* § 15-30-2103, MCA.
[102] *Id.* Montana's inflation factor was enacted by initiative in 1980. Sec. 2, I.M. No. 86, approved Nov. 4, 1980.

Rate Table			
If your taxable income is			
More than	But not more than	Then your tax is	Less
$0	$2,700	1% of taxable income	
$2,700	$4,700	2% of taxable income	$27
$4,700	$7,200	3% of taxable income	$74
$7,200	$9,700	4% of taxable income	$146
$9,700	$12,500	5% of taxable income	$243
$12,500	$16,000	6% of taxable income	$368
	More than $16,000	6.9% of taxable income	$512

If a couple files a joint return, the rate table applies to the couple's combined taxable income. However, if the couple files separate returns, then each spouse is able to use the rate table. In most cases, two-earner couples filing separate state returns will have a lower overall tax bill, but there are exceptions to the rule. These exceptions generally come into play when one couple is in a very low tax bracket. For example, a September 18, 2009, DOR memo[103] provided two examples where a couple would have had lower overall tax liabilities by filing joint returns. When one spouse had $2,000 in adjusted gross income (AGI) and the other spouse had $38,000 in AGI, the couple saved $285 by filing jointly. Additionally, when one spouse had $6,000 in AGI and the other spouse had $54,000 in AGI, the couple saved $23 by filing jointly.

More than 55% of married couples in Montana file separate state income tax returns.[104] Yet less than 3% of couples file separate returns at the federal level.[105] From this, one can speculate that 52% (55% - 3% federal average) of the couples filed separately in the hopes of having a lower tax liability, while 3% may have filed separately for nontax reasons. For example, spouses who keep their finances separate may choose to file separately to avoid joint and several liability.[106] Otherwise, one spouse could be on the hook for the other spouse's failure to properly report income and deductions.

In a December 2, 2009, DOR memo,[107] 2,548 couples were identified who may have paid more money by filing separately, half of which had an extra tax of only $20 or less.[108] Of these 2,548 couples, the DOR assumed that some couples were trying to keep their finances separate, some couples had a long-term tax strategy, and some couples did not understand how the $5,000 cap on federal tax deductions is increased to a $10,000 cap

[103] Memorandum from Dan Dodds, Tax Policy Analyst, to Dan Bucks, Director of the Mont. Dept. of Rev., at 6-7 (Sept. 18, 2009) (hereinafter "DOR Memo 1"), *available at* *http://revenue.mt.gov/content/committees/legislative_interim_committee/married_filing_separately.pdf* (last visited Aug. 29, 2011).
[104] *Id.* at 1.
[105] *See* Internal Revenue Service, Statistics and Income Division, *Tax Statistics: Table 1.2 All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2007, available at:* http://www.irs.gov/pub/irs-soi/07in12ms.xls.
[106] *See* section 15-30-2602(2), MCA.
[107] Memorandum from Dan Dodds, Senior Economist, to Dan Bucks, Director of the Mont. Dept. of Rev. (Dec. 3, 2009) (hereinafter "DOR Memo 2").
[108] *Id.* at 1.

when a joint return is filed.[109] Last, many retired couples with pension income would have had lower taxable income with a joint return.[110] Part of this is due to complexities regarding the $3,600 exemption in § 15-30-2110(2)(c), MCA, for pension and annuity income, which phases out when federal AGI is between $30,000 and $33,600.[111] As it stands, the phaseout is not increased to $60,000 when couples file jointly.[112] Consequently, retired couples understandably hypothesize that separate returns will result in lower taxes. However, by trying to obtain the pension exemption, some couples are not obtaining the full value of their standard deductions and allowable exemptions.[113] The only true way to avoid this pitfall is to prepare tax returns both ways. However, some retired couples certainly gain a tax advantage by filing separately. For example, if two retired spouses with pension income each have $30,000 in federal AGI, then they would lose $7,200 in pension exemptions by filing jointly.

5. INDIVIDUAL INCOME TAX PROVISIONS IN THE STATES: THE WISCONSIN LEGISLATIVE FISCAL BUREAU PUBLICATION

In January 2011, the Wisconsin Legislative Fiscal Bureau produced an informational paper entitled Individual Income Tax Provisions in the States. The informational paper outlines the major provisions of income tax in 43 states and the District of Columbia. Given the wealth of information in this paper, it is attached as Appendix D.

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[109] *See id.*
[110] *Id.* at 3, 6.
[111] *Id.* at 5-6.
[112] Section 15-30-2110(2)(c)(ii)(B), MCA.
[113] DOR Memo 2, *supra* note 107, at 6.

APPENDIX A

House Joint Resolution No. 13 (2011).

APPENDIX B

Montana Department of Revenue, Biennial Report: July 1, 2008 – June 30, 2010, Individual and Corporate Income Taxes, pp. 53-80 (2010).

Montana Department of Revenue, Biennial Report: July 1, 2008 – June 30, 2010, Tax Expenditures, pp. 205-271 (2010).

APPENDIX C

Legislative staff outline for HJR 61 (2007) regarding conformity with the federal system.

Legislative Services staff attorney report for HJR 61 (2007) regarding delegation of legislative authority.

APPENDIX D

Rick Olin and Sandy Swain, Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (Jan. 2011).