



Montana Department of Revenue




Mike Kadas
Director

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Governor

MEMORANDUM OF LEGAL ADVICE

TO: Mike Kadas, Director

FROM: Jessica DeMarois and Tony Zammit, Tax Counsel 

DATE: January 4, 2018¹

SUBJECT: H.R. 1 2017 Part II, § 11011- Pass-Through Deduction

QUESTIONS PRESENTED

How does the newly created IRC § 199A impact Montana income tax law?

BRIEF ANSWER

Montana law, specifically §§ 15-30-2131 and 15-30-2132, MCA, gives Montana taxpayers the choice between itemizing deductions, including the items referred to in § 161 of the Internal Revenue Code (IRC), or taking the standard deduction against their Montana income tax.

H.R. 1 creates a new deduction in Part VI, Subchapter B, Chapter 1 of Title 26 of the IRC. The new deduction, codified in Part VI at IRC § 199A, is equal to 20% of "qualified business income" (QBI) a taxpayer receives from a pass-through entity. Inclusion of IRC § 199A in Part VI permits QBI as an item of deduction under IRC § 161.

Because Montana law permits as deductions the items referred to in IRC § 161, taxpayers who itemize their Montana deductions will be able to claim this new "below the line" federal deduction for qualified pass-through income when computing their Montana income tax. However, taxpayers who elect to take the standard deduction in Montana will not be eligible to take the new deduction against their Montana income tax.

ANALYSIS

Introduced as the Tax Cuts and Jobs Act in the United States House of Representatives, H.R. 1 became Public Law No. 115-97 (H.R. 1) on December 22, 2017. This new federal

¹ This memorandum updates the previous memorandum issued December 28, 2017, for typographical errors.

legislation makes significant changes to the Internal Revenue Code that affect Title 15 of the Montana Code Annotated. The Department is reviewing H.R. 1 and analyzing its full impact to Montana tax law. This memorandum only addresses the new deduction for individuals with QBI from pass-through entities.

Part II, § 11011(a) of H.R. 1 adds IRC § 199A, which creates a new deduction for individual taxpayers who have QBI from pass-through entities. See H.R. 1, 115th Cong. § 11011 (Dec. 22, 2017), at 10. The provisions of this new deduction apply to partnerships, LLCs, S Corps, and sole proprietors, with some specific exceptions. H.R. 1 amends several key sections of the IRC to make the QBI deduction available for taxpayers who take the standard deduction as well as those who itemize deductions against their federal income taxes. *Id.*, at 17.

The new § 199A is available as a deduction against federal income taxes for taxpayers who take the standard deduction as a result of § 11011(b)(2). *Id.* That section of H.R. 1 amends IRC § 63(b) to permit non-itemizing taxpayers to take the standard deduction as well as the amounts permitted by the new IRC § 199A. *Id.*

H.R. 1 also adds QBI to the list of allowed deductions under Part VI, Subchapter B, Chapter 1 of the IRC for taxpayers who itemize. *Id.*, § 11011(a), at 10. The new deduction is specifically not allowed in computing a taxpayer's federal adjusted gross income through an amendment to IRC § 62(a). This prevents IRC § 199A from being used to reduce a taxpayer's federal adjusted gross income, meaning it cannot be taken as an "above the line" deduction. See § 11011(b), at 17.

The § 11011 changes to the IRC have substantial impacts on the Montana income tax law structure. Section 15-30-2110, MCA, includes the definition of adjusted gross income (AGI) in Montana. Montana AGI is generally defined as a taxpayer's "federal adjusted gross income as defined in section 62 of the Internal Revenue Code," with specific Montana additions (§ 15-30-2110(1)(a)-(g), MCA) and deductions (§ 15-30-2110(2), MCA). Section 15-30-2110, MCA. As described above, because IRC § 199A is specifically excluded as an above the line deduction under the amendment to IRC § 62, a taxpayer who claims the standard deduction under § 15-30-2132, MCA, when calculating state income tax has no mechanism by which QBI could be deducted from his or her Montana income taxes. See § 11011(b), at 17. Therefore, this means that Montana taxpayers who take the standard deduction will not be entitled to claim the IRC § 199A deduction for QBI against their Montana income tax liability.

There is, however, a distinction between taxpayers who claim the Montana standard deduction as set forth in § 15-30-2132, MCA, and taxpayers who itemize their deductions as permitted by § 15-30-2131, MCA. Deductions allowed in Montana for computing net income includes "the items referred to in sections 161 . . . subject to . . ." certain nondeductible exceptions which do not apply to the new IRC § 199A. § 15-30-2131(1)(a), MCA. IRC § 161 permits "the items specified in . . ." Part VI, Subchapter B, Chapter 1 of the IRC to be used as a deduction. 26 U.S.C. § 161. Part VI is where H.R. 1 enacts new section IRC § 199A. See H.R. 1, § 11011(b), at 17.

As the items referenced at IRC § 161 are specifically included as a part of the permitted deductions which can be claimed against a Montana taxpayer's net income, this new IRC § 199A is an item of deduction available to offset QBI from pass-through entities to itemized individual income tax returns in Montana.

The Department has received a number of inquiries about the specific application of the amendment to IRC § 63(d) to the above analysis. The amendment to IRC § 63(d) added the following language at (3):

(d) For purposes of this subtitle, the term "itemized deductions" means the deductions allowable under this chapter other than . . . (3) the deduction provided in section 199A.

See H.R. 1, 115th Cong., § 11011, at 17. At the federal level, the result is clear: the deduction provided in IRC § 199A is available to individuals who itemize deductions at the federal level while simultaneously not included in the definition of the term "itemized deduction" for purposes of Chapter 1 of Subtitle A. *Id.*

However, this amendment to IRC § 63(d) does not change the Department's analysis and anticipated impact on Montana's tax code. Other states have specifically adopted IRC § 63(d) to define state itemized deductions. See, e.g., Idaho Code § 63-3022(j)(2) ("there shall be allowed as a deduction . . . [i]temized deductions as defined in section 63 of the [IRC] . . ."); N.M. Stat. Ann. § 7-2-2(N)(2) ("net income" means . . . base income adjusted to exclude . . . an amount equal to the itemized deductions defined in Section 63 of the [IRC].") (emphasis added). It appears that a taxpayer in one of those states may not deduct QBI as an itemized deduction against their state income tax, because new IRC § 199A is specifically excluded from the definition of "itemized deductions" as a result of the amendments to IRC § 63(d).

Montana, however, does not conform to the federal definitions of itemized deductions and standard deductions. See §§ 15-30-2131 and § 15-30-2132. Moreover, unlike other states, Montana itemized deductions are not calculated with regard to the federal definition of "itemized deductions" at IRC § 63(d). Montana's itemized deductions are listed in § 15-30-2131, MCA. The statute provides the starting place for calculating itemized deductions for Montana income tax purposes. As described therein, the allowed deductions in computing net income are, among other things, "the items referred to in [IRC] § 161" subject to specifically articulated exceptions. Section 15-30-2131(1)(a), MCA. Turning then to IRC § 161, that section of federal law permits "the items specified in . . ." Part VI, Subchapter B, Chapter 1 of the IRC. As described previously, new § 199A is included in Part VI, Subchapter B, Chapter 1 of the IRC.

Although IRC § 63(d) was amended to exclude new IRC § 199A from the definition of "itemized deductions" at the federal level, the plain language of Montana law permits the deduction of QBI for taxpayers who itemize deductions against Montana income.

CONCLUSION

Individual income tax filers in Montana are treated differently for purposes of the newly enacted IRC § 199A depending on whether they itemize or take the standard deduction. This distinction exists due to the way Montana has codified portions of the Internal Revenue Code. Standard filers in Montana are not eligible to take the qualified business income deduction. Itemizers in Montana will be allowed to take the deduction pursuant to § 15-30-2131, MCA, as IRC § 199A was enacted as one of the items referenced by IRC § 161.