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Revenue and Transportation Interim Committee

60th Montana Legislature

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Date: February 8, 2007

To: Revenue and Transportation Interim Committee

From: Lee Heiman, Staff Attorney

RE: State Income Tax Conformity With Federal Income Tax Law

Currently, 36 states base their individual income tax on federal starting points: either federal taxable income or federal adjusted gross income. Montana bases individual income taxes on federal adjusted gross income.

A Montana taxpayer reports federal income taxes first and starts the Montana return with the amount of federal adjusted income reported on the federal return. From that starting point, Montana law requires that certain income be added back in and allows certain income to be subtracted. So whenever changes are made to federal law that affect how federal adjusted gross income is determined, Montana's income taxes are directly affected. Montana has also adopted other provisions of federal income tax law that don't directly affect the determination of federal adjusted gross income but do directly affect income taxes. Provisions of the federal Internal Revenue Code are adopted by Montana "as amended", so any change made by Congress automatically affects Montana income taxes without any Montana legislative participation.

A few states base individual income taxes on a federal starting point as Montana does and automatically conform to federal law as the federal law changes, but most states enact periodic legislation to adopt federal law as of the date of that legislation, something like a bond validation act. The legislation may also contain provisions that reject federal tax provisions.

Legally there is a problem with automatically adopting federal law for state income tax purposes. A few states have sidestepped the problem of unconstitutional delegation of legislative powers by determining that a state tax enacted by the legislature can use changing federal law for the computation of the amount payable to the state because the legislature determines whether the tax exists or will continue to exist and the tax is not established independent of the state's legislative action. See In re Estate of West, 226 Neb. 813, 415 N.W.2d 769 (1987).

In Montana there is an established precedent involving unlawful delegation of legislative authority. Lee v. State of Montana, 195 Mont. 1, 635 P.2d 1282, 38 St. Rep. 1729 (1981), was a case involving the 55 m.p.h. speed limit. To continue to receive federal highway funding, the legislature provided that if Congress required a speed limit the Attorney General “shall” by proclamation adopt a speed limit and “shall” make further proclamations if federal law was changed. The Montana Supreme Court held that the proclamation powers were an unconstitutional delegation of authority of legislative authority to the Attorney General. Because of the mandatory directions to the Attorney General, the Court said, “A more blatant handover of the sovereign power of this state to the federal jurisdiction is beyond our ken.” (Lee, supra, page 9.) The Court, citing Wallace v. Commissioner of Taxation, 289 Minn. 220, 184 N.W.2d 588 (1971), continued, “cases which recognize the right of a legislature to adopt as a part of its enactments existing federal laws and regulations also except from that right any adoption of changes in the federal laws or regulations to occur in the future.” (Lee, supra, page 9.) The Court said an enactment by the legislature incorporating federal requirements is constitutional, even if it was made in response to federal requirements. The Court then further stated, “Moreover, we see no constitutional infirmity, if an emergency of the sort presented here arose, in granting such proclamation power to a state official, if it were only for the interim between legislative sessions.” (Lee, supra, page 10.)

Also of relevance is the special legal status accorded taxation. In Lee, supra, the Court’s acknowledgment of authority to adopt existing statutes and regulations was based upon a tax case: Wallace v. Commissioner of Taxation, supra. The recent Montana Supreme Court decision, Elliott v. Department of Revenue, 2006 MT 267, 334 Mont. 195, 146 P.3d 741 (2006), was a controversy involving the Montana Constitution’s right to know provision. The opinion was decided on procedural grounds, but Justice Warner wrote a concurring opinion. Justice Warner quoted McCulloch v. Maryland, 17 U.S. 316, 428 (1819):

It is admitted that the power of taxing the people and their property, is essential to the very existence of government, and may be legitimately exercised on the objects to which it is applicable, to the utmost extent to which government may choose to carry it.

Justice Warner, after discussing state taxing power, concluded that “the State’s interest in enforcing its authority to tax is sufficiently ‘weighty or compelling’ that it may, in limited and appropriate circumstances, circumscribe the right to know.”

Harmonizing unconstitutional delegation of power, the ability to adopt emergency interim federal law and regulations, and the state’s nearly overriding power of taxation, I suggest a bill that would provide for adoption of federal law each session and allow for interim adoption of federal tax law and regulation through the rulemaking process by the Department of Revenue, subject to specific delegation.

The biennial adoption of federal law is straightforward, but the interim adoption by the Department of Revenue should establish criteria for the Department to consider for adoption to constitute lawful delegation. The criteria might include such things as whether the not adopting the change would result in a substantial unforeseen loss of revenue; whether the federal provision, by its terms, requires immediate adoption; whether adopting or not adopting a change would jeopardize future legislative decisionmaking; and whether there are specific administrative policy ties to federal taxes that would affect the administration of state taxes. The adopted changes would be effective only for tax years ending at a specified time--prior to the year in which the regular session meets or some other determinable date.

A separate bill each session would actually adopt federal tax law and regulations as of the applicability date of the bill. The bill could also specifically reject specific federal law or regulation and constitute the permanent adoption of federal tax law and regulations that may have been temporarily adopted in the interim.

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