Montana Department of Revenue

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DETAILED SUMMARY OF DEPARTMENT OF REVENUE PROPOSED 2007 LEGISLATION

1. Abusive Tax Avoidance Transactions (ATAT)

Purpose: To provide the tools needed to address cases of abusive tax sheltering by adopting legislation based on the Multistate Tax Commissioner's model proposal.

Background: Illegal, abusive tax shelters artificially reduce federal and state taxes, shifting the tax burden to honest taxpayers. Inconsistent filing positions taken on state returns by multi-state businesses artificially reduce the state tax base, placing honest businesses at a competitive disadvantage. Because federal and state tax evasion depends on complexity and lack of transparency, traditional audit enforcement is difficult and expensive. State legislation is needed to mirror the provisions of the federal law related to abusive tax shelters because the IRS does not adequately share information about out-of-staters engaging in abusive shelters affecting Montana, and because some shelters are established solely to evade state taxes. A. uniform state solution to inconsistent filing positions is needed to prevent state-level abuse. The Multistate Tax Commission is proposing model legislation that addresses both areas, which, if enacted in Montana, would protect the state's tax base, bring tax evaders to justice, and promote uniformity in state tax treatment.

Fiscal Impact: Adopting legislation that provides the Department with the tools needed to address abusive tax avoidance schemes will, over time, act to increase general fund revenues. Additional revenue eventually received will depend on a variety of factors, including the amount of audit resources dedicated to addressing specific abusive tax sheltering schemes, but is likely to be in the millions of dollars.

2. Withholding for Nonresident Sales of Property

Purpose: To ensure that taxes are properly paid on Montana source income in cases where a nonresident sells Montana property for a net capital gain.

Background: Each year nonresidents are involved in sales of property located in Montana. These nonresidents may or may not be reporting the net gain or loss from the sale in their state of residency, but may not understand that they have a legal obligation to file an income tax return with the State of Montana and report the gain or loss here as well. This is because any income earned on the sale of Montana property is Montana-source income and subject to Montana income tax. In many cases, nonresidents simply never file in Montana and pay the tax legally owed the state. Research performed by the Department for tax year 2003 indicated that 70% of nonresidents failed to file a Montana tax return and pay taxes on gains from the sale of Montana property. This legislation would require withholding on any net gain from the sale of Montana property by a nonresident at the time of sale to ensure that (1) the nonresident becomes aware of their legal requirement to pay tax on the Montana gain, and (2) ensure that tax legally owed the state on the transaction is actually collected. Withholding would not apply to sales where the gains are deferred for tax purposes.

Fiscal Impact: Requiring withholding on sales of Montana property by a nonresident will act to increase state general fund revenue by the amount of tax liability currently not being paid on these transactions.

3. Real Estate Investment Trusts (REIT)

Purpose: The purpose of this legislation is to promote fairness in taxation by closing a business loophole that allows certain income received and paid by Real Estate Investment Trusts (REITs) to escape state taxation entirely.

Background: REITs do not pay taxes on the income they earn in Montana to the same degree as other businesses. This result occurs because of the unique deduction that REITs enjoy under federal law for dividends they pay to their owners. The dividend paid deduction effectively eliminates most, if not all, their income tax in Montana, even though they operate in the same manner as other businesses in the state and enjoy the benefits of state and local services. The dividends received by corporations or non-resident individuals from REITs are also not taxable in Montana. This REIT loophole can be closed either by requiring the REIT to pay taxes directly by disallowing the unique REIT dividend deduction paid or requiring the REIT owners to pay the tax to Montana. One or the other of these measures may be used depending on whether the REIT is a publicly traded corporation or is privately held.

Fiscal Impact: Disallowing the dividends-paid deduction for REITs would subject the income to REITs to state income tax. This would act to increase state general fund revenue.

4. Grantor Trusts

Purpose: To establish income reporting requirements for grantor trusts to ensure proper reporting and payment of taxes.

Background: Various grantor trusts are used, in some cases, to hide abusive tax shelters or income or prevent the discovery of assets that can be used to satisfy tax debts. While many grantor trusts are used for legitimate purposes, they constitute a "black hole" in the income tax reporting system. Their exclusion from the normal income tax reporting system is an invitation to tax abuse that too many taxpayers have accepted. Grantor trusts are owned by the grantor or another person and any income received by the grantor trust is to be included in the grantor's tax return as if the income was received by the grantor. Montana statute is silent on the treatment of grantor trusts and the reporting by grantor trusts. Legislation is needed to include grantor trust in the definition of disregarded entity and establish filing requirements for grantor trusts in addition to providing substantial penalties for failure to file and disclose a grantor trust.

Fiscal Impact: There will be a positive revenue impact by preventing or correcting the underreporting of income and improving the collection of accounts receivables. Because there is no data on grantor trusts, it is a daunting task to estimate the impact quantitatively.

5. Improve Collections Management

Purpose: Provide the Department of Revenue with the statutory tools needed to effectively manage Montana's accounts receivable.

Background: (1) Electronic Filing of Wage and Fund Levies. Provide the department the ability to file wage and fund levies electronically with lending institutions and businesses that have the capability to receive these documents electronically. (2) Electronic filing of Warrants for Distraint. Provide the department the ability to file warrants for distraint (tax items) electronically and to apply to property of the taxpayer located in any county in the state. (3) Increase Authority to Collect on "Non-Tax" Debt. Allow the department to file warrants for distraint and initiate levy actions for "all" debts owed to the state that the department collects. (4) Out-of-State-Debt Collections. Seek legislation and appropriation authority that would improve the department's collection capabilities for out-of-state taxpayers' delinquent tax liabilities by allowing the department to hire on a contingency basis out-of-state collection professionals. (5) Include retail telecommunication excise tax, rental vehicle tax, and lodging facilities taxes as trust taxes. Include these taxes in the list of taxes for which officers and owners of business are liable for trust taxes. (6) Make warrants for distraint follow the IRS process concerning date of validity.

Fiscal Impact: There may be some general fund costs associated with the out-of-state debt collections.

6. Prohibition of Sale of Tax Information

Purpose: Prohibition on the sale of tax information not currently regulated by state statute.

Background: Specifically prohibit tax preparers from selling any taxpayer information gathered through the filing of tax returns. Some preparers are not regulated by state law and information gathered in the preparation of tax returns could be sold. This legislation would not amend provisions relating to licensed CPAs and would not apply to those professionals.

Fiscal Impact: None

7. Create Equity in Gift Certificates

Purpose: Reclaim unclaimed store-value cards funds for Montana.

Background: Currently, all unclaimed value on stored value cards sold in Montana is remitted to the card owner's state of domicile, i.e., Delaware. Legislation is needed to require all unused value on lost gift cards purchased in Montana not be sent to the state of domicile, but rather the state in which the card was purchased or last used. Gift card sales are in the billions of dollars each year and it is estimated that between 8% and 12% of all value in gift cards is never used.

Fiscal Impact: Increase in unclaimed property that may eventually become general fund money.

8. Insurance Stuffing

Purpose: The purpose of this proposed legislation is to promote fairness in taxation and enhance competition in the private sector by closing a business loophole that currently allows certain businesses to channel income that normally would be subject to state income taxes into wholly owned insurance subsidiaries that pay tax only on the insurance premiums issued during the tax year.

Background: The net income of corporations operating in Montana is subject to the state corporate license (income) tax. But insurance companies are subject to the insurance premium's tax (a tax paid on the amount of premiums issued during the year), and state law generally exempts these types of companies from all other taxes. Corporations may control a variety of wholly-owned subsidiaries. Included among them, a wholly-owned insurance company. Some corporations have taken the income of non-insurance company subsidiaries and channeled that income into the wholly-owned subsidiary ("insurance stuffing"). Because the insurance subsidiary pays only premium tax in Montana or other states, the otherwise taxable income from the non-insurance subsidiaries escapes taxation (33-2-705(4), MCA). This tax avoidance scheme reduces general fund revenues and provides an unfair competitive advantage to firms with wholly owned insurance company subsidiaries, relative to similarly situated firms that do not have an insurance subsidiary.

Fiscal Impact: Preventing "insurance stuffing" will require corporations to report and pay tax on income that otherwise would escape income taxes, thereby increasing state general fund revenues. A precise estimate of the revenue impact is not available.

9. <u>Endowment Credit Clarification</u>

Purpose: The purpose of this legislation is to ensure the appropriate use of the income tax credit for contributions to a qualified charitable endowment by amending state laws to make taxpayer contribution directed specifically toward real or personal property owned or held by the charitable organization ineligible for the credit.

Background: On December 29, 2005, the department, at the request of the Commissioner of the Office of Higher Education, issued a preliminary Memorandum Opinion finding that contributions to a qualified endowment for the specific purpose of building real property for the charitable organization sponsoring the qualified endowment qualified for the charitable endowment tax credit. This legislation would provide that contributions for buildings, equipment, and other facilities for charitable organizations would be explicitly ineligible for the credit. The current endowment credit sunsets on December 31, 2007, so the 2007 session is an appropriate time to consider this change.

Fiscal Impact: To the extent that this amendment to state law results in a reduction in contributions qualifying for the charitable endowment tax credit, state general fund revenues will increase.

10. <u>Clarify Confidentiality Laws</u>

Purpose: This legislation would clarify what information the Department can share with the LFD, Auditor, and OBPP.

Background: There currently exists some ambiguity as to what information may be provided to the LFD and OBPP. This legislation would clarify Montana's disclosure laws as it relates to tax information exchanged between these agencies and the department.

Fiscal Impact: None.

11. Direct Interstate Distribution

Purpose: This legislation amends provisions in the liquor code to address the U.S. Supreme Court decision in Granholm v. Heald concerning the constitutionality of state restrictions on access by out-of-state wineries to their markets.

Background: In 2005, the U.S. Supreme Court determined the laws in Michigan and New York restricting access to their respective markets by out-of-state wineries violated the Commerce Clause. In particular, Michigan's law required out-of-state wineries to sell, in general, only to Michigan wholesale distributors, while Michigan wineries to could ship directly to retail outlets. Montana's statutes may be subject to challenge based upon this decision. Legislation is needed to provide—subject to defensible limits—access by out-of-state wineries to Montana retailers comparable to the access allowed for Montana small wineries. The legislation should include controls to protect pubic health and safety and the collection of taxes,

12. Residency Requirements for Liquor Licenses

Purpose: This legislation amends provisions in the liquor code to address a Montana District Court decision concerning the constitutionality of state residency requirements for liquor licensees and establishes standards to qualify publicly traded companies as licensees.

Background: In 2005, the First Judicial District Court of Montana determined that Montana's laws requiring liquor licensees to be residents of Montana violated Holiday Inn's rights under the Commerce Clause. Montana's statutes require revision based upon this decision.

Fiscal Impact: None.

13. Clarify Jurisdiction of Courts of Limited Jurisdiction Regarding Sales of Liquor to Minors

Purpose: This legislation will clarify that all courts of limited jurisdiction have jurisdiction in prosecutions involving violations of the liquor code.

Background: Currently, 16-6-201,MCA, provides that in misdemeanor criminal actions brought pursuant to violation of the liquor code, district courts and justice of the peace courts have concurrent jurisdiction. A question has arisen as to the power of other courts of limited jurisdiction, such as municipal courts, to hear these cases. This legislation would clarify that all courts of limited jurisdiction have the power to decide cases alleging criminal violation of the liquor code.

Fiscal Impact: None.

14. Trust Tax Refunds

Purpose: Establish provision on the handling of refund of trust taxes (withholding; retail telecommunications excise tax and lodging facility use tax).

Background: Clearly establish that, in cases of refunds for trust taxes, the refund must be refunded to the individual who paid the tax. If the individual cannot be found, the refund becomes unclaimed property or state general money.

Fiscal Impact: May be increased unclaimed property activity and some increase in general money.

15. Withholding for Nonresident Mineral and Oil and Gas Royalty Payments
Nonresidents who have Montana source income fail to file income taxes at a rate of 78%. In a study of oil and gas royalty payments made by a major producer, 85% of Montana residents receiving payments filed an income tax form, only 22% of nonresidents did. A total of 1,030 individuals received royalty income; 844 individuals who were paid a total of $1.9 million failed to file a return. For comparison, wage earners who have money withheld from their paychecks file at a rate of 97%.

A system of tax withholding for royalty payments will ensure that royalty owners pay the appropriate tax.

16. Follow Federal Practice of Withholding for Retirement Fund Withdrawals
Retirees who receive a lump sum payment on an early withdrawal of retirement funds have a federal requirement for withholding of taxes. There is no similar state requirement. Retirees often spend the distribution only to find out too late that they owe state taxes. Withholding would make it clear to retirees that taxes are owed at the state level and would ensure that funds are available.

17. Make Corporation Tax Statute of Limitations Equal to Individual Income Tax
Increase the period of statute of limitations from 3 to 5 years, which will equalize the corporate limit to the 5-year statute for individuals. This will provide the department the necessary time to examine corporation tax returns and to improve its audit coverage of corporations. Most importantly, it will correct an inequity where individuals are subject to audit for a longer period than corporations. This inequity is further underscored by the fact that some limited liability companies file as corporations and some such companies file under the individual income tax—making the statute of limitations subject to taxpayer manipulation through a choice of law.

18. Improved Exchange of Information Among State Agencies
Various state agencies are responsible for licensing and/or monitoring of individuals and businesses throughout the state. Currently, DOR uses a small portion of this data in identifying non-filers, or for the potential of underreporting of income. This proposal will involve enacting legislation to clarify and improve the use of state agency information to ensure equitable and effective compliance with state and local tax laws. The legislation would also clarify and improve the use of revenue information by other agencies for their administrative purposes, consistent with federal and state laws on confidentiality of tax information. Finally, the legislation would grant the department access to confidential criminal justice information for the purpose of Title 16 alcohol compliance and for tax fraud investigations.

19. **Generally Revise Tax Code**

a. **Penalty and Interest Clean-Up**

Purpose: The purpose of this proposed legislation is to promote fairness in taxation and enhance compliance with Montana's tax laws by appropriately amending existing penalty and interest statutes where warranted, and providing new and consistent penalty statutes.

Background: (1) Interest on overpayments. 15-30-149, MCA, addresses situations in which taxpayers have paid more than their legal liability. Subsection (4) provides that interest is due on an overpayment from the due date of the return or from the date of the overpayment, "whichever date is later." For delinquent returns (late filing), this is not an issue where the taxpayer pays the taxes due when the return is filed; the date of the overpayment is the date the return is filed, and the taxpayer is entitled to interest only from the time when the taxpayer actually paid tax. An issue of fairness arises when the taxpayer files a delinquent return for a tax year in which excess withholding or quarterly estimated tax had been paid. Subsection (4) of 15-30-149, MCA, states that "[w]ith respect to taxes paid by withholding or by estimate, the date of overpayment is the date on which the return for the tax year is due." Currently, a taxpayer who has excess taxes withheld in TY2003, but does not file a TY2003 return until April 15, 2006, would be entitled to interest from the date the return is due, April 15, 2004. In this case the state is rewarding, or at least holding harmless, a taxpayer who files a delinquent return. To eliminate this perverse taxpayer incentive, Montana statute should be modified to reflect federal law, which provides that "in the case of a return of tax for a return which was filed after the last date prescribed for filing such return (determined with regard to extensions), no interest shall be allowed or paid before the date the return is filed."
(2) Penalties. Penalties for fraud, substantial underreporting, and failure to file returns or out-of-state federal Revenue Agent Reports (RARs) must be established or strengthened and be consistent for all tax types and programs. This would include penalties for not filing the actual federal tax return where required. (3) All penalties and interest should be reviewed for consistency.

Fiscal Impact: Eliminating the fundamental unfairness in current law overpayment interest rules, and strengthening fraud and other penalty provisions will, over time, result in enhanced compliance with the tax code, and result in additional revenue for the state general fund. At this time, it is not possible to provide a precise estimate of the timing and size of these impacts.

b. **Lodging Tax Base Definition**

Purpose: The purpose of this legislation is to clarify who pays, and how payment is made, for lodging facility and accommodations sales taxes in situations involving intermediaries.

Background: 15-65-111, MCA, provides that "[t]here is imposed on the user of a facility a tax at a rate equal to 4% of the accommodation charge collected by the facility." This definition should be amended to clarify who collects and pays the tax in transactions that involve service fees paid to hotel intermediaries, such as Expedia.com or Hotels.com. For example, a traveler may book a room at a motel in Montana through one of these intermediaries. The cost of the room is $80; but the intermediary charges a $20 fee to book the room for the traveler. The intermediary then charges the traveler $100 plus tax, with the tax applied to the entire $100 which includes the cost of the room and the intermediary's fee. Under current law, the motel operator remits to the state the accommodations and sales tax owed on the $80 charge for the room, but the intermediary retains the amount of tax initially paid by the traveler on the $20 fee. Legislation is needed to clarify that the hotel intermediary fee is subject to the lodging facility tax and accommodation tax, and that intermediary is responsible for remitting the tax to the state.

Fiscal Impact: Clarifying that intermediaries are responsible for remitting to the state any lodging facility or accommodations sales taxes collected on intermediary fees would act to increase revenue from these sources.

c. S Corp Conformity

Purpose: Require S corp conformity to federal rules for taxpayer simplicity and proper tax compliance.

Background: The failure of Montana law to follow federal rules on special entity owners of S corporations causes confusion and opens Montana to some income abuses.

Fiscal Impact: None.

d. Definition of "Person"

Purpose: This legislation would update the definition of a "person," and coordinate the general definition found in 1-1-201, MCA, with that found in 15-1-201, MCA, in order to remove any ambiguities found in current law, and make application of the term "person" more consistent across statutes.

Background: "Person," as defined in 1-1-201, MCA, currently includes only corporations and natural persons. This general definition should be amended to include pass-through entities, such as partnerships, and limited liability companies (LLCs).
If the controlling definition in 1-1-201, MCA, cannot be amended through a code commissioner bill, then the definition of "person" at 15-1-201, MCA, for the purposes of Title 15 (except Chapters 30 (income tax) and 31 (corporations)), should be amended to include limited liability companies.

Fiscal Impact: None.

e. Definition of a Qualifying Child

Purpose: This legislation will eliminate some confusion, and enhance simplicity and compliance with the tax code by amending the state definition of a qualifying child to correspond to the federal definition of qualifying child for individual income tax purposes, while controlling for known problems with the federal definition.

Background: The federal definition of a "qualifying child" for federal income tax purposes changed for 2005 and is inconsistent with Montana's definition. In order to be considered a qualifying child for federal income tax purposes an individual must meet the following four tests: (1) relationship; (2) age; (3) residency (the child must live with the taxpayer for more than half of the year); and (4) support (the child did not provide over half of his or her own support for the year). This legislation will clarify the definition of a “qualifying child” for state tax purposes to make it generally consistent with the federal definition while fixing known problems with the federal definition. For example, Montana statute requires the support test to be met by the taxpayer (the parent) and not the qualifying child. This eliminates a problem with the federal definition that technically allows one sibling to claim another sibling as a dependent for federal tax purposes, thereby artificially reducing the sibling's federal tax liability.

Fiscal Impact: None.

f. **<u>SB407 Clean Up Limit on Federal Tax Deduction for Trusts</u>**

Purpose: Clean up some of the SB407 provisions.

Background: Effective January 1, 2005, there is a federal tax limitation of $5,000 single/$10,000 joint for individuals. However, no similar provision was set forth for trusts, even though all other provisions of SB407 apply. This has caused confusion but, at this time, the position was taken that the federal tax deduction was not limited for trusts.

Fiscal Impact: None.

g. **<u>Clarify Filing Requirements of Estates</u>**

Purpose: Clarification of filing requirements for estates.

Background: The code section (72-16-906, MCA) requires filing with Montana only estates that are required to file if the death was before January I, 2005. It is silent on what to do for anything after that, so presumably that means there isn't a filing requirement. However, the law still exists (72-3-1006, MCA) stating that if they have a probate and the estate filed a federal estate tax return, the department has to certify that no taxes are due. Even though there effectively is not a state estate tax because of how the laws calculate it, sound audit procedures mean that some type of written submission should be reviewed before a certificate specific to an estate can be issued.

Fiscal Impact: None.

h. Extension of Time for Individual Income Tax Returns

Purpose: Clarification and coordination with the federal extension to file individual income tax return.

Background: Section 15-30-144, MCA, currently provides for an automatic four-month Montana extension and an additional two-month Montana extension upon applying for a federal extension. Beginning with tax year 2005, the Internal Revenue Service is granting an automatic extension of six months, provided that federal Form 4868 is filed before April 15. The Internal Revenue Service has eliminated the four-month and two-month extensions beginning with 2005. In addition, federal law provides that an individual who resides outside the United States or Puerto Rico and is a U.S. citizen is granted an automatic six-month extension of time to file a tax return without having to apply for an extension using Form 4868. Individuals living outside the U.S. are not eligible for a Montana extension, as the Montana statute specifically states that the taxpayer must apply for a federal extension.

Fiscal Impact: None.

i. Municipal Corporations

Purpose: Repeal 15-1-201(3), MCA. which requires the department to collect certain information annually from the municipal corporations to assist the department in conducting its work. The information required is either not necessary or is not useful and, therefore, the department recommends repeal of this subsection in statute.

Background: Audit Recommendation #5C in the financial compliance audit for the two years ended June 30, 2004, recommended legislation be sought to amend 15-1-201, MCA, to reflect the current information needs of the department. The statute as written requires the department to collect information annually from municipal corporations. The requirements in this section of law do not assist the department in conducting its duties, as the information is unnecessary and does not lend itself to be useful in how the department conducts its business.

Fiscal Impact: None.

j. Improved Exchange of Information Among State Agencies

Purpose: Grant the Department of Revenue access to confidential criminal justice information for the purpose of Title 16, alcohol compliance, and for tax fraud investigations, as well as improve exchange of information among state agencies for the purpose of tax compliance.