



# Montana Department of Revenue



Mike Kadas  
Director

Steve Bullock  
Governor

## MEMORANDUM OF LEGAL ADVICE

**TO:** Mike Kadas, Director  
**FROM:** Dan Whyte, Chief Legal Counsel  
**DATE:** January 12, 2018  
**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. Inclusion of IRC § 199A in Part VI permits QBI as an item of deduction under IRC § 161.

Upon an initial reading, it appeared HR 1 would allow taxpayers who itemize their Montana deductions to 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 would not be eligible to take the new deduction against their Montana income tax.

Congress’ amendments to the federal tax code via H.R. 1 are substantial. The Department continues reviewing H.R. 1 and analyzing its full impact to Montana tax law. This process is fluid and the full impacts will not be known for many months. However, because some of the effects of H.R. 1 are immediate, this is an expedited analysis providing several potential interpretations for consideration as to the application of IRC § 199A to Montana returns. Ultimately, the culmination of the varying opinions as to whether the 20% QBI is allowed as a deduction on a Montana individual income tax return has created disagreement about the application of the new pass-through deduction. By

adopting IRC § 199A as a deduction, but purposefully excluding QBI from the definitions of federal adjusted gross income and itemized deductions in the IRC, it is clear that Congress' intent is to prevent the QBI deduction from being claimed at the state level. Taking Congress' intent into consideration, it may be that deductions for QBI in Montana should not be allowed.

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 legislation makes significant changes to the Internal Revenue Code that affect Title 15 of the Montana Code Annotated. This memorandum only addresses the new deduction for individuals with QBI.

Part II, § 11011(a) of H.R. 1 adds IRC § 199A, creating a new federal deduction for individual taxpayers who have QBI. See H.R. 1, 115<sup>th</sup> 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 Section 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.

## ANALYSIS

The Department has conducted an initial review of the plain language of the application of § 199 to Montana deductions allowed. 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). § 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. 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, it appears at first blush that this new IRC § 199A may be an item of deduction available to offset QBI 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, 115<sup>th</sup> 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.* This is an example of language in H.R. 1 that demonstrates Congress’ intent to limit the § 199A deduction to the federal income taxes.

However, this amendment to IRC § 63(d) may not have the intended effect on Montana’s tax code. Other states have specifically adopted IRC § 63 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, is not so clear. Montana 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. § 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, Montana law may permit the deduction of QBI for taxpayers who itemize deductions against Montana income. If the intent of Congress is not taken into account, this is a likely conclusion that the courts may make.

There are other interpretations of the impacts of H.R. 1 as applied to Montana law that should be considered here. As previously indicated it does appear that the United States Congress did not intend for the IRC § 199A QBI deduction to apply against state income taxes. These other interpretations are consistent in that they conform to the apparent intent of Congress to not include QBI as a state deduction for Montana taxpayers who itemize deductions.

One interpretation of Montana law involves a specific review of IRC §§ 62 and 161. Federal adjusted gross income (FAGI) is defined at IRC § 62. Within the amendments provided by H.R. 1, the QBI deduction is specifically excluded from FAGI thereby it is excluded as a deduction against Montana income tax purposes as well. It follows that IRC § 161 can be read to incorporate IRC § 63. Montana law provides that Montana taxpayers may claim either the standard deduction, as specified at § 15-30-2132, MCA, or the deductions specified at § 15-31-2131, MCA. Under § 15-30-2131, MCA, there are allowed as deductions the items referred to in IRC § 161. As IRC § 161 provides: “In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).” This interpretation concludes that IRC § 63 cannot be excluded from Montana’s reference to IRC § 161 at § 15-30-2131 as that would be contrary to the language of that IRC § 161. Put another way, because § 161 incorporates by reference IRC § 63, including the federal definition of “itemized deductions” at IRC § 63(d), it is thereby adopted in Montana.

Another interpretation of the new IRC § 199A revolves around the “Other Definitions” that exist at IRC § 199A(e)(1). In relevant part, § 199A(e) provides: “Other definitions. For purposes of this section . . . (1) Taxable income shall be computed without regard to the deduction allowable under this section.” This interpretation has been presented as a potential means of separating IRC § 199A from the deductions allowable as itemized deductions in Montana, because it requires the deduction to be disregarded for purposes of determining “taxable income.”

Another interpretation involves the actual function of the QBI provision. The QBI provision is termed as a deduction because it comes out of FAGI. In essence, it takes the form of an exemption. There is a subtle difference between a business deduction, which is usually based on an expenditure, and an exemption, which is a non-taxable fraction of

net income not related to an expense (such as interest on a Roth IRA or a municipal bond). A deduction must be ordinary and necessary, while an exemption is self-referential and acts more like a credit. Because IRC § 199A meets these exemption characteristics, it may be treated as an exemption, thereby avoiding any potential conflict with § 15-30-2131, MCA, as a deduction.

Finally, another interpretation makes it clear that Montana frequently aligns its tax laws with those passed by Congress in the Internal Revenue Code and recognizes this as codified in § 15-30-2620(2), MCA:

**Department rules — conformance with Internal Revenue Code.** (1) The department may adopt rules and may require facts and information to be reported as it considers necessary to enforce the provisions of this chapter.  
(2) If a term is not defined in this chapter, the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code.

There are circumstances in Title 15 of the MCA when Montana has adopted IRC provisions. For instance, Montana has adopted IRC §§ 67 and 68 by incorporating the two percent floor on miscellaneous itemized deductions and the overall limitation on itemized deductions for state income tax purposes, though the Montana Code Annotated does not refer to those code sections explicitly. IRC §§ 67 and 68 both refer to “itemized deductions.” and Montana relies on the federal term “itemized deductions” under § 68 despite not specifically adopting the term in the Montana Code Annotated. By applying § 15-30-2620(2), MCA, and recognizing Montana’s history of relying on the federal definition, it can be concluded that Montana has adopted the federal definition of “itemized deductions” through its incorporation of the applicable sections into Montana’s state income tax scheme. See, also, 2017 Montana Individual Income Tax Return, Form 2. Under this application, the Department can conclude that the history of the adoption of the federal definition for “itemized deductions” in § 63(d), as applied to Montana, would disallow IRC § 199A deductions for state tax purposes.

## CONCLUSION

Individual income tax filers in Montana may be treated differently for purposes of the newly enacted IRC § 199A depending on the application of H.R. 1 to Montana tax law. While Montana has codified portions of the Internal Revenue Code without wholesale adoption, Montana has also relied on federal definitions by incorporation that raise an ambiguity as to the application of IRC § 199A to Montana state tax returns.

