

# **PROPOSED STUDY PLAN FOR AN INTERIM STUDY OF THE INDIVIDUAL INCOME TAX AND OPTIONS FOR REVISION**

Prepared for the Revenue and Transportation Interim Committee

by

Megan Moore, Legislative Research Analyst  
Montana Legislative Services Division

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## **Introduction and Background**

House Joint Resolution No. 13 requires an interim study of and options for revising the individual income tax system. The study ranked first of the 16 polled studies.

The individual income tax is the largest source of state revenue, accounting for \$717.8 million in fiscal year 2010. The tax was first imposed in Montana in 1933. Over the years, the tax rates and income tax brackets have changed a number of times. Tax rates are indexed for inflation and, for tax year 2012, ranged from 1% on the first \$2,600 of taxable income to 6.9% on taxable income in excess of \$15,600.

An individual's Montana income tax liability is calculated by adjusting total income by federal and Montana adjustments, subtracting itemized deductions or the standard deduction, and subtracting the personal exemption to arrive at Montana taxable income. Montana taxable income is then multiplied by the tax rate table. This amount is reduced by the 2% capital gains credit and other Montana tax credits to reach the Montana individual income tax liability.

There were 32 bills to change the individual income tax introduced during the 62nd session of the Montana Legislature, but only four of the bills passed the Legislature and were signed by the Governor. With the exception of SB 11, these bills dealt with administration and enforcement of the individual income tax:

- HB 641 requires the Department of Revenue to report certain tax expenditures in the biennial report;
- SB 11 reduces the withholding tax rate on proceeds from lottery winnings;
- SB 166 allows a taxpayer with an individual income tax liability for the current year of \$200 or less to pay the amount due without penalty or interest when filing an extended return;
- SB 413 clarifies the due date of individual income tax returns when the due date of the return falls on a federal holiday or during federally declared disasters not observed in Montana.

In addition, a mail poll to override the Governor's veto of SB 199 is in progress, with results due on June 21, 2011. That bill would revise provisions related to the administration of individual income taxes, specifically penalties on delinquent individual income taxes.

Other bills introduced to amend the individual income tax system that did not pass include the following:

- new or expanded deductions, credits, or exemptions for health care, property taxes paid, military income, retirement income, long-term care insurance, alternative fuel motor vehicles, college savings plans, donations to student scholarship organizations, and capital gains from the sale of business property and stock of a Montana business;
- limiting the definition of a dependent minor child for individual income tax purposes to require school attendance;
- equalizing the deduction for federal income taxes between trusts and individuals;
- elimination or temporary reduction of certain individual income tax credits;
- indexing the federal income tax deduction to the consumer price index;
- repeal of the individual income tax with replacement by a sales tax;
- creation of an earned income tax credit;
- addition of a high income personal income tax bracket; and
- decoupling certain provisions from the federal income tax.

As originally drafted, HJR 13 directed the assigned interim committee to evaluate the advantages and disadvantages of replacing the individual income tax with a sales and use tax or other revenue sources of the committee's discretion. The Senate Taxation Committee removed that language,<sup>1</sup> narrowing the resolution to a study of the individual income tax and directing the assigned committee to consider options for revising the individual income tax.

### **Study Issues**

The reasons for HJR 13 as listed in the "whereas" clauses of the study are:

- the Montana individual income tax is the largest source of state general fund revenue;
- Montana's individual income tax laws generally conform with the Internal Revenue Code of 1986, as amended;
- the state has enacted a variety of state-specific deductions, exclusions, exemptions, credits, and other special tax provisions that may not achieve their intended purposes and may increase the complexity of complying with the state's individual income tax laws and increase the costs of administering and enforcing the state's individual income tax laws;
- simplifying Montana's individual income tax laws would further enhance taxpayer compliance with state income tax laws, reduce administrative and enforcement costs, improve predictability for Montana's taxpayers, provide stability of revenue for the state general fund, and promote economic development;
- the Revenue and Transportation Interim Committee has recently conducted limited studies of the state's individual income tax structure.

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<sup>1</sup>See Minutes of the Senate Taxation Committee for April 19, 2011.

### **Directions from the Legislature**

The resolution directs the Committee to:

- review the provisions of Montana's individual income tax laws, including but not limited to:
  - ▶ general provisions;
  - ▶ conformity with federal income tax law;
  - ▶ provisions related to married filing jointly and married filing separately; and
  - ▶ Montana-specific deductions, exclusions, exemptions, credits, and other special tax provisions;
- conduct an analysis that evaluates the individual income tax in terms of obligation or incidence;
- conduct an analysis of Montana-specific deductions, exclusions, exemptions, credits, and other special tax provisions to determine:
  - ▶ whether the deductions, exclusions, exemptions, credits, and special income tax provisions are meeting their intended purposes;
  - ▶ the costs of the deductions, exclusions, exemptions, credits, and special income tax provisions;
- analyze compliance and administrative costs associated with the state individual income tax, including but not limited to:
  - ▶ taxpayer compliance costs; and
  - ▶ auditing and enforcement costs;
- assess the complexity of the state's individual income tax structure;
- consider options to simplify the state's individual income tax structure, including but not limited to options related to:
  - ▶ conformity with federal income tax laws;
  - ▶ the individual income tax base;
  - ▶ the reduction or elimination of deductions, exclusions, exemptions, credits, and other special tax provisions;
  - ▶ revising Montana's individual income tax rate structure;
  - ▶ the filing provisions for married taxpayers;
- evaluate the advantages and disadvantages of revising the state's individual income tax structure according to the criteria described above.

### **Study Design**

With two other significant interim studies assigned to the Revenue and Transportation Committee (the SJR 17 study on valuing centrally assessed property for tax purpose and the SJR 23 study of the tax treatment of nonprofits), the Committee should consider how to focus Committee and staff efforts and how much time to devote to the HJR 13 study. Recent work by the Revenue and Transportation Interim Committee addressed two areas of interest included in the HJR 13 resolution:

- the filing status of married taxpayers, SJR 37 (2009-2010); and
- the linkage of state and federal income taxes, HJR 61 (2007-2008).

In addition, House Bill No. 641, sponsored by Rep. Betsy Hands, requires the Department of

Revenue to include information in the biennial report that will be useful for the HJR 13 study. HB 641 requires the following information:

- the dollar amount attributable to loss of revenue from income tax exemptions, credits allowed against the personal income tax, deductions from income, and any other identified preferential treatment of income;
- the year of enactment and provision of the code granting the benefit; and
- the number of taxpayers benefiting from each.

The law will take effect on July 1, 2011; however, the report is not required to be sent to the governor until 20 days before the legislative session.

The HJR13 study can be approached in four phases that follow the resolution outline:

Phase I            Build a foundation of facts and evidence regarding the Montana individual income tax structure and incidence of the individual income tax.

Phase II            Consider options for revision of the individual income tax.

Phase III           Develop, through Committee discussion and action, findings and conclusions about the individual income tax.

Phase IV           Identify, through Committee discussion and action, legislative options for addressing any recommended changes to the individual income tax.

**Phase I: Building a foundation**

Compiling a foundation of facts and data about the Montana individual income tax includes the following elements:

- An overview and legislative history of the Montana individual income tax structure, including conformity with the federal individual income tax, provisions related to married filers, and Montana-specific deductions, exclusions, exemptions, credits, and other special tax provisions.
- A summary of other states' income tax structures.
- A quantitative analysis of individual income tax incidence by income level and the costs of Montana deductions, exclusions, exemptions, credits, and special income tax provisions.
- An analysis of taxpayer compliance costs and Department of Revenue auditing and enforcement costs.

**Phase II: Considering options for revision**

Having developed a foundation of facts and evidence, the Committee will consider options for revising the individual income tax. This phase will include:

- Consideration of whether the deductions, exclusions, exemptions, credits, and special income tax provisions are meeting their intended purposes.
- Assessment of the complexity of the individual income tax structure.

- Consideration of options to simplify the individual income tax, including options related to conformity with federal tax laws, the individual income tax base, reduction or elimination of deductions, exclusions, exemptions, credits, and other special tax provisions, revision of the tax rate structure, and provisions related to married taxpayers.

### **Phase III: Evaluating options**

The Committee will now evaluate the options considered in Phase II within the context of the information gathered in Phase I. The resolution directs the Committee to evaluate the advantages and disadvantages of revising the individual income tax structure using the criteria of tax incidence.

The Committee will develop findings and conclusions in this phase.

### **Phase IV: Legislative options and Committee recommendations**

The findings and conclusions developed in Phase III may lead the Committee to develop options for legislative consideration, including draft legislation.

If the Committee determines that no action should be taken at this time, it should consider making a clear statement to that effect and supporting the statement with findings and conclusions developed as a result of the study.

### **Proposed Committee Meeting Schedule and Work Plan**

HJR 13 requires the study to be completed by September 15, 2012. The proposed Committee schedule includes eight meetings. With the first meeting composed largely of organizational matters and the final meeting in November 2012 devoted to the revenue estimating resolution, the Committee will have six meetings to complete the HJR 13 study. All meetings except the final meeting are scheduled as two-day meetings and the Committee should anticipate spending about one-quarter of one day during each two-day meeting on the HJR 13 study.

The following is a proposed schedule for conducting the study:

#### **September 15-16, 2011**

- ▶ Staff briefing on the Montana individual income tax structure including conformity with the federal individual income tax, provisions related to married filers, and Montana-specific deductions, exclusions, exemptions, credits, and other special tax provisions.
- ▶ Staff review of the legislative history of conformity with federal individual income tax, provisions related to married filers, and Montana-specific deductions, exclusions, exemptions, credits, and other special tax provisions.
- ▶ Committee work session to focus study and identify core areas of interest.
- ▶ Committee requests for additional research and analysis.

#### **December 1-2, 2011**

- ▶ Responses to Committee requests from previous meetings.
- ▶ Overview of other states' individual income tax structures.
- ▶ Briefing on the individual income tax incidence by income level.
- ▶ Briefing on the costs of Montana deductions, exclusions, exemptions, credits, and special income tax provisions.
- ▶ Consideration of the intended purposes and whether those purposes are being met.

#### February 16-17, 2012

- ▶ Responses to Committee requests from previous meetings
- ▶ Panel discussion on individual income tax structure with discussion of options for revision.

#### April 26-27, 2012

- ▶ Responses to Committee requests from previous meetings.
- ▶ Consider options to revise Montana's individual income tax.
- ▶ Refine findings and conclusions previously developed.
- ▶ Develop, refine, or adopt new or additional findings and conclusions.
- ▶ Direct additional research and analysis necessary for evaluation of options or draft legislation.

#### July 19-20, 2012

- ▶ Responses to Committee requests from previous meetings.
- ▶ Establish, revise, and adopt final findings and conclusions.
- ▶ Discuss options previously identified; propose and discuss additional options.
- ▶ Recommend options, including draft legislation, for legislative consideration.
- ▶ Review, revise, and adopt outline of Committee report to the Legislature.

#### September 13-14, 2012

- ▶ Final responses to Committee requests from previous meetings.
- ▶ Adopt final findings and conclusions.
- ▶ Adopt final recommendations, including draft legislation or recommendation to continue status quo.
- ▶ Review draft final report.

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