

**OVERVIEW OF INDIVIDUAL INCOME TAX FILING OPTIONS IN THE  
UNITED STATES, MONTANA, AND THE OTHER STATES, AS WELL AS AN  
EVALUATION OF BENEFITS AND DRAWBACKS IN REVISING MONTANA'S  
RATE SCHEDULES**

Prepared for the Revenue and Transportation Committee  
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**INTRODUCTION**

The purpose of this report is to analyze the specific issues presented in Senate Joint Resolution 37 (SJ 37) from the 2009 Regular Session. The specific issues are as follows:

- 1) Review the rationale for allowing married taxpayers in Montana to file separately on the same form and review the legislative history related to how married taxpayers may choose to file individual income tax returns;
- 2) Evaluate the benefits and drawbacks of revising the method for filing individual income tax returns by married taxpayers, including an analysis of changes to tax rate schedules if the existing method of filing were changed; and
- 3) Consider policy options related to the filing method used by married taxpayers.

For the purposes of this report, issue one is addressed in section 1, and issues two and three are merged together and addressed in section 2, because the benefits and drawbacks of revising Montana's filing system are frequently policy matters that may be classified as a benefit for some taxpayers and a drawback for other taxpayers.

**1. INDIVIDUAL INCOME TAX FILING OPTIONS IN THE UNITED STATES, MONTANA, AND THE OTHER STATES**

Issue one in SJ 37 is addressed using a three-step approach. In step one, the federal history regarding income tax filing options is presented. A basic understanding of federal filing options of the past and present is helpful when evaluating policy issues. In step two, Montana's history regarding income tax filing options for married taxpayers is presented, which includes an analysis of when Montana taxpayers started to file separately on the same form. A basic understanding of Montana's filing options is helpful when evaluating the filing options in other states. In the last step, a survey of individual income tax filing systems in 43 states and the District of Columbia is presented. When all three steps are combined, it is easier to make decisions regarding potential changes to Montana's rate schedule and methods of filing.

## a. The Federal History of Individual Income Tax Filing Options

In 2007, Montana was one of 43 states with an individual income tax.<sup>1</sup> However, in order to understand the structures of the Montana filing system and the system of the other states, a basic understanding of the federal individual income tax filing system is helpful. As such, this section provides a very basic history of important developments in the federal individual income tax filing system. It is in no way a comprehensive review of the federal filing system, as numerous articles have been written on this topic.<sup>2</sup>

The Sixteenth Amendment to the United States Constitution authorizing an unapportioned income tax was adopted on March 1, 1913.<sup>3</sup> Eight months after the amendment, Congress passed a statute that taxed individual income at a rate of 1%, with progressive surtaxes when net income exceeded \$20,000.<sup>4</sup> The original 1913 tax form was primarily designed for individuals, as opposed to married couples. The instructions stated that a “return shall be made by every citizen of the United States”.<sup>5</sup> And, while a “joint return” was an option for married individuals, there was no tax advantage to filing one. In fact, the early instructions during this era cautioned that when spouses each had separate income they “should make a separate return”.<sup>6</sup> This advice was especially true for high-income taxpayers that were subject to highly progressive surtaxes. In 1918, these rates started at 1% for individuals with \$6,000 in net income to 65% for those with incomes above \$1,000,000.<sup>7</sup>

### i. 1930 – 1947: Community Property vs. Non-Community Property States and the Assignment of Income Problem

The highly progressive surtax encouraged high-income taxpayers to look for ways to lower their federal tax liabilities through income splitting. That is, if they could each take a bite at the tax rate table, they would ultimately be subject to less tax. In community property states it was common for taxpayers to claim that the income of the community (*i.e.*, the husband and the wife) was equally owned by each spouse, and separate returns were filed using this theory.<sup>8</sup> Additionally, in non-community property states couples tried to shift income from one spouse to the other through contracts that were enforceable under state law.<sup>9</sup> These arrangements opened the floodgates of litigation between the

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<sup>1</sup> Rob Reinhardt, Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States*, at 1 (Jan. 2009).

<sup>2</sup> See, e.g., Patricia A. Cain, Symposium, *Taxing Families Fairly*, 48 SANTA CLARA L. REV. 805 (2008); Wendy Richards, Comment, *An Analysis of Recent Tax Reforms from a Marital-Bias Perspective: It is Time to Oust Marriage from the Tax Code*, 2008 WIS. L. REV. 611 (2008); Lora Cicconi, Comment, *Competing Goals Amidst the "Opt-Out" Revolution: An Examination of Gender-Based Tax Reform in Light of New Data on Female Labor Supply*, 42 GONZ. L. REV. 257 (2006); Stephen W. Mazza & Tracy A. Kaye, *Restricting the Legislative Power to Tax in the United States*, 54 AM. J. COMP. L. 641 (Supp. 2006); Shari Motro, *A New "I Do": Towards a Marriage-Neutral Income Tax*, 91 IOWA L. REV. 1509 (2006); Ann F. Thomas, Symposium 1999 Part One: *Marriage and the Income Tax Yesterday, Today, and Tomorrow: A Primer and Legislative Scorecard*, 16 N.Y.L. SCH. J. HUM. RTS. 1 (1999); Amy C. Christian, *The Joint Return Rate Structure: Identifying and Addressing the Gendered Nature of the Tax Law*, 13 J. L. & POLITICS 241 (1997); Richard B. Malamud, *Allocation of the Joint Return Marriage Penalty and Bonus*, 15 VA. TAX REV. 489 (1996).

<sup>3</sup> Cain, *supra* note 2, at 808.

<sup>4</sup> *Id.*

<sup>5</sup> United States Internal Revenue, *1913 Form 1040*, at 4 (instructions).

<sup>6</sup> United States Internal Revenue, *1918 Form 1040*, at 3 (instructions).

<sup>7</sup> *Id.* at 3 (table and instructions for calculation of surtax).

<sup>8</sup> Cain, *supra* note 2, at 809.

<sup>9</sup> See *id.* at 815.

Collector of Internal Revenue (IRS) and individual taxpayers. Eventually the United States Supreme Court had an opportunity to weigh in on income splitting in what are now two very famous federal income tax cases.

In the 1930 case of *Lucas v. Earl*, a married couple agreed to share all of their income jointly.<sup>10</sup> The agreement was enforceable under state law, and one spouse could demand payment from the other. As such, the couple filed separate returns and took advantage of the progressive rate structure. The IRS disagreed with this arrangement, and in a short unanimous opinion Justice Holmes determined that the assignor of income was liable for tax on the assigned earnings.<sup>11</sup> Holmes famously stated that this essentially attributed fruits to “a different tree from that on which they grew”<sup>12</sup> The *Lucas* case is frequently cited by courts when one individual attempts to assign income to another individual.<sup>13</sup>

In the 1930 case of *Poe v. Seaborn*, a married couple from a community property state (Washington) split the community income 50/50, and each couple filed separate returns.<sup>14</sup> Unlike *Lucas v. Earl*, the U.S. Supreme Court held that it was appropriate for the husband and wife to each claim ½ of the community income from the property.<sup>15</sup> The Court ruled this way, as both spouses had a vested interest in the other spouse’s wages under state law, and the earnings of the spouses belonged to the community as a whole.<sup>16</sup>

In 1937, President Roosevelt addressed Congress concerning revenue loss from community property states.<sup>17</sup> In response, the U.S. Treasury proposed that all married individuals should file a joint return that uses the same tax rate schedule as a single person.<sup>18</sup> The proposal would have increased taxes on married couples, and was therefore defeated on moral grounds.<sup>19</sup> Interestingly, six states became temporary community property states during this timeframe in order to take advantage of the federal tax rate structure.

## **ii. 1948-1951: Major Change to the Rate Schedule to Encourage Joint Returns and the Addition of Head of Household Rates**

In 1948, Congress decided to deal with the community property problem by encouraging married individuals to file a joint return.<sup>20</sup> If spouses decided to aggregate income and losses they were allowed to take advantage of tax rates that were twice as wide as those of a single person.<sup>21</sup> This effectively gave the citizens of the several states the ability to pay the same amount of tax, regardless of state community property law. For example,

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<sup>10</sup> *Lucas v. Earl*, 281 U.S. 111, 113-114 (1930).

<sup>11</sup> *Id.* at 114-115.

<sup>12</sup> *Id.* at 115; Motro, *supra* note 2, at 1517.

<sup>13</sup> See, e.g., *Commissioner v. Banks*, 543 U.S. 426, 433 (2005); *Sparkman v. Commissioner*, 509 F.3d 1149, 1157 (9th Cir. 2007).

<sup>14</sup> *Poe v. Seaborn*, 282 U.S. 101, 108-109 (1930).

<sup>15</sup> *Id.* at 118.

<sup>16</sup> *Id.* at 117.

<sup>17</sup> Cain, *supra* note 2, at 816.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* (citing Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1391 (1975)).

<sup>20</sup> *Id.* at 817.

<sup>21</sup> *Id.*

according to the 1948 federal tax table, a married couple with no dependents and \$5,000 of taxable income would pay \$544 in tax using a joint return.<sup>22</sup> Likewise, if the husband and wife each had \$2,500 in income and they both filed separate returns, they would each face \$272 in tax (*i.e.*, exactly ½ of a married filing jointly return). Using the same example, this hypothetical couple would have paid \$689 in tax on a joint 1947 return (*i.e.*, before the change in the law), while paying \$330 each by filing separate 1947 returns.<sup>23</sup> In other words, the couple saved \$29 dollars in 1947 by filing separate returns, prior to the change in the law.

In 1952, another rate table was introduced into the federal system entitled “head of a household”.<sup>24</sup> The new rate table was designed in response to arguments from single-parent taxpayers that they should be allowed more tax benefits when they provided a home for dependents.<sup>25</sup> The special rate entitled qualified single taxpayers to obtain better tax treatment than a single person, but less favorable treatment than a couple using the married filing jointly rate structure.

### iii. 1968: Single Taxpayers Complain About Rate Structure and the Creation of the “Marriage Tax Penalty”

Congress eventually faced complaints from single individuals who claimed that it was unfair to give married individuals rate structures that were twice as wide as single individuals.<sup>26</sup> This claim was made on the theory that single individuals had a higher proportional cost of living based on “economies of scale” and the fact that they were not taxed on the imputed income of spouses who stayed home providing household services.<sup>27</sup> For example, if both a single and married individual could rent an apartment for \$500 per month, the single person’s effective cost would be \$500 per month while a married individual’s effective cost would be \$250 (*i.e.*, 50%). Moreover, if one married spouse obtained income from a job while the other spouse performed household services at home, the married couple arguably received the benefit of both a lower tax rate and the benefit of not having to pay someone to perform household repairs, care for children, cook meals, wash clothes, and clean the house. This type of arrangement can be referred to as a “marriage tax bonus.”

In 1969, Congress responded to this issue by changing the rate table for married individuals “so that single taxpayers would never pay more than 120% what a married couple would pay on the same amount of income.”<sup>28</sup> However, the new rate tables did not end the debate, and economists pointed out that a “marriage tax penalty” was now being imposed on married spouses who decided to re-enter the workforce, which in turn reduced the economic effect of their labor.<sup>29</sup> For example, if a husband was making

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<sup>22</sup> United States Internal Revenue, *1948 Form 1040*, at 4 (tax table).

<sup>23</sup> United States Internal Revenue, *1947 Form 1040*, at 4 (tax table).

<sup>24</sup> United States Internal Revenue, *1952 Form 1040*, at 4 (tax table).

<sup>25</sup> Cain, *supra* note 2, at 818-819 (2008); *see also* 26 U.S.C. §§1(b), 2(b) (2000) (defining head of household and providing the rates).

<sup>26</sup> Cain, *supra* note 2, at 818.

<sup>27</sup> *Id.*

<sup>28</sup> Cain, *supra* note 2, at 818; Motro, *supra* note 2, at 1531.

<sup>29</sup> Thomas, *supra* note 2, at 54.

\$50,000 a year, he would be in a higher tax bracket and a wife who decided to enter the workforce would be taxed at this higher bracket, as opposed to the lower bracket that could be obtained through separate filing.

**iv. 2001: Congress Revises Rate Table to Mitigate the “Marriage Tax Penalty”**

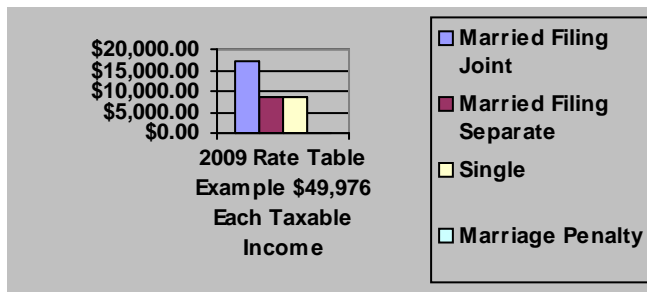
In 2001, Congress attempted to mitigate the marriage tax penalty by making the rate brackets twice as wide for married individuals as single individuals.<sup>30</sup> However, the rate brackets were not designed to be twice as wide for all levels of income. Instead, the rate brackets started to shrink between the 25% to 28% brackets.<sup>31</sup> Essentially, this made a hybrid rate structure between the rate structure of 1969 that favored single taxpayers, and the rate structure of 1948 that favored married individuals.<sup>32</sup> Married individuals with lower levels of income received the marriage tax bonus, while married individuals with higher levels of income were subjected to the married tax penalty.

**v. 2009: Today’s Federal Rate Structure: Examples and Statistics**

Pursuant to the 2009 federal rate table, the marriage tax penalty kicks in when married individuals filing separate returns have over \$68,525 in taxable income or when a married couple earns over \$137,050 in taxable income and files a joint return.<sup>33</sup> Before this point, an individual filing a single return and an individual filing a married filing separate return face the same rate of tax.

*A. Modern Example of How Married Individuals and Single Individuals Pay the Same at Lower Levels of Income*

If we assume that a husband and wife each make \$49,976 in taxable income (*i.e.*, \$99,952 joint), the couple has a tax liability of \$17,369 if they file jointly, and \$17,362 (*i.e.*, \$8,681 each) if they file separately. Additionally, a single taxpayer with \$49,976 in taxable income has a tax liability of \$8,681, which is the same amount as a married taxpayer who files separately.



SOURCE: Department of the Treasury, Internal Revenue Service, *1040: Instructions 2009*, at 82, 88 (Tax Tables).

<sup>30</sup> Motro, *supra* note 2, at 1532, 1566.

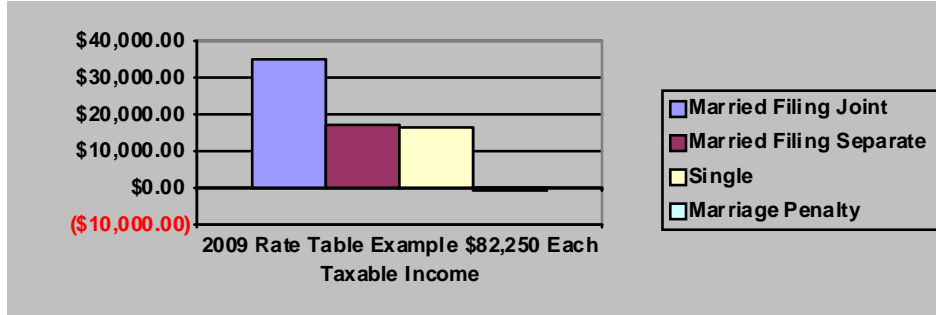
<sup>31</sup> *Id.* at 1566.

<sup>32</sup> *Id.*

<sup>33</sup> Department of the Treasury, Internal Revenue Service, *1040: Instructions 2009*, at 101 (Tax Rate Schedules).

*B. Modern Example of How Married Couples Pay More When Income Increases*

If we assume that a husband and wife each make \$82,250 in taxable income (*i.e.*, \$164,500 joint), the couple has a tax liability of \$35,136 if they file jointly and \$17,568 each if they file separately. Additionally, a single taxpayer with \$82,250 in taxable income has a tax liability of \$16,750, which is \$818 less than a married taxpayer who files separately. Consequently, it can be argued that an \$818 marriage tax penalty exists in this example.

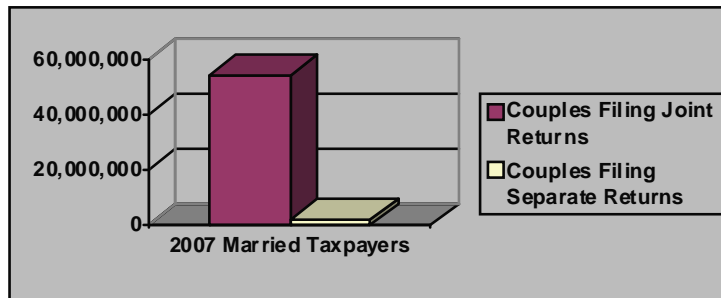


SOURCE: See Department of the Treasury, Internal Revenue Service, *1040: Instructions 2009*, at 101 (Applying Tax Rate Schedules).

*C. 2007 Federal Filing Statistics*

In 2007, 54,065,030 returns were filed by married persons filing jointly, while only 2,730,935 (*i.e.*, 1,365,468 couples) returns were filed by married persons filing separately.<sup>34</sup> Consequently, less than 3% of couples decided to use the married filing separately rate table. Additionally, 21,169,039 head of household returns were filed, while 64,926,879 single taxpayer returns were filed. Lastly, 86,923 surviving spouse returns were filed. Statistically, these findings can be reported as follows:

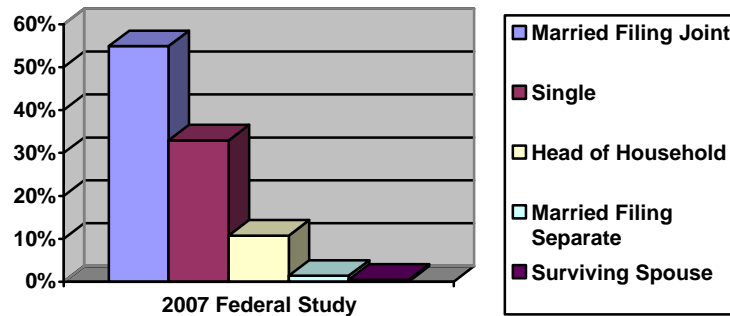
*Less Than 3% of Married Couples File Separate Federal Returns<sup>35</sup>*



<sup>34</sup> Internal Revenue Service, Statistics and Income Division, *Tax Statistics: Table 1.2 All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2007*, available at: <http://www.irs.gov/pub/irs-soi/07in12ms.xls>.

<sup>35</sup> See *id.*

*Percentage of Individual Taxpayers Using the Federal Rate Structures*<sup>36</sup>



**b. Montana’s History of Individual Income Tax Filing Options, Including an Analysis of the Rationale for Allowing Married Taxpayers to File Separately on the Same Form**

This subsection provides an overview of important statutory changes in Montana law regarding filing options. Additionally, it summarizes the results from two interim committee studies where changes to the Montana filing system were contemplated. Interestingly, the ability to file separately on the same form was implemented by the Department of Revenue (DOR) in 1972, because it was difficult to obtain and compare two married filing separate returns for one couple during an audit or review. This subsection concludes with an overview of Montana’s current rate structure and some of the filing pitfalls for married taxpayers.

**i. 1933: Montana Enacts Income Tax**

Montana enacted a graduated income tax in 1933 during the Great Depression. As enacted, a “taxpayer” was defined as any person or fiduciary.<sup>37</sup> A person, in turn, was required to “make, under oath, a return stating specifically the items of his gross income and the deductions and credits allowed.”<sup>38</sup> However, the tax return requirement did not kick in unless the person had a certain level of income. Specifically, a single person (or married but not living with or supporting a husband, wife, or family) was entitled to earn \$999.99 net income, while a married person who was living with the other spouse was entitled to earn \$1,999.99 net income before the filing requirement came into play. However, if both of the spouses earned income the statute provided that no more than \$2,499.99 in “aggregate net income” could be earned before a return was required.<sup>39</sup>

Similar to the federal return during this timeframe, a joint return was technically an option, but it provided no monetary advantage other than the fact that a person could

<sup>36</sup> See *id.*

<sup>37</sup> Sec. 1, Ch. 181, L. 1933.

<sup>38</sup> *Id.* § 14.

<sup>39</sup> *Id.* There were also gross income guidelines.

potentially pay less in tax preparation fees by filing jointly. Indeed, there was only one tax rate table for both married and single taxpayers. The rate table imposed a 1% tax on the first \$2,000 of net income, a 2% tax on the second \$2,000, a 3% tax on the third \$2,000, and a 4% tax on everything above \$6,000.<sup>40</sup> Hence, if a husband and wife earned \$2,000 each, they could save \$20 by doing separate returns.<sup>41</sup> Interestingly, in order to file a tax return, a person had to pay a \$1 filing fee to the State Board of Equalization (Board).<sup>42</sup>

## ii. 1957: More People Required to File a Return

The tax return filing requirement stayed static until 1957, at which point a law made it harder to escape the filing obligation. A single person (or married but not living with or supporting a husband, wife, or family) was entitled to earn \$599.99 net income, while a married person who was living with the other spouse was entitled to earn \$1,199.99 net income before a return was required.<sup>43</sup> Moreover, the rate table became more progressive.<sup>44</sup>

Unlike the 1933 statute, the joint return was not listed as an option but the Board was given the power by the Legislature to create forms and instructions.<sup>45</sup> It is therefore difficult to know whether the Board adopted a joint return, but it would still be more advantageous to file married filing separately.

## iii. 1963: The Joint Income Tax Return Is Provided for by Statute

In 1963, Senate Bill No. 102, which provided for the election of filing joint returns, easily passed the Senate and the House without a single negative vote.<sup>46</sup> The bill contained a provision that read:

(2) In accordance with instructions set forth by the board, every taxpayer who is married and living with husband or wife and is required to file a return may, at his or her option, file a joint return with husband or wife even though one of the spouses has neither gross income nor deductions. If a joint return is made, the tax shall be computed on the aggregate taxable income and the liability with respect to the tax shall be joint and several.<sup>47</sup>

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<sup>40</sup> *Id.* § 2.

<sup>41</sup> The \$20 savings was calculated as follows: If the married individuals filed jointly the first \$2,000 in net income (after exemptions) would produce a \$20 tax, while the second \$2,000 would produce a \$40 tax, for a combined total of \$60. Yet, if the married individuals filed separate returns they would each pay \$20 in tax, for a grand total of \$40.

<sup>42</sup> Sec. 19, Ch. 181, L. 1933.

<sup>43</sup> Sec. 2, Ch. 227, L. 1957.

<sup>44</sup> A 1% tax was imposed on the first \$1,000 of income, a 1.5% tax on the second \$1,000, a 2% tax on the third \$1,000, a 2.5% tax on the fourth \$1,000, a 3% tax on the fifth \$1,000, a 3.5% tax on the sixth \$1,000, a 4% tax on the seventh \$1,000, and a 5% tax on everything above \$7,000. Sec. 2, Ch. 228, L. 1957.

<sup>45</sup> Sec. 1, Ch. 227, L. 1957.

<sup>46</sup> Senate Journal, 38<sup>th</sup> Sess., p. 175 (MT 1963); House Journal, 38<sup>th</sup> Sess., p. 571 (MT 1963).

<sup>47</sup> Sec. 1, Ch. 201, L. 1963.



A review of the Senate Taxation Committee minutes does not shed light on the reasoning behind the bill.<sup>48</sup> However, the minutes of the House Ways and Means Committee shows more. Specifically, the chairman of the Board testified that “many of the changes in [the] bill do not change the effect of the existing provisions.” Additionally, the chairman indicated the purpose was to “expressly provid[e] for the filing of joint returns by husband and wife and to provide that the tax liability is joint and several”.<sup>49</sup> It is therefore plausible that a joint return was implicitly allowable from 1957 through 1963. However, since there was only one tax rate table it was generally more advantageous to file separate returns in a two-income household. Moreover, due to the 1963 change in the law, both spouses faced tax liabilities if a joint return was filed, even if the error or omission was caused by the other spouse.

**iv. 1966 - 1972: Montana Legislative Council Report on Montana Taxation and the Start of Married Filing Separately on the Same Form**

In 1966, the Legislative Council (Council) undertook a major study of the existing tax structure in Montana. The study created numerous staff reports, in addition to a 91-page Report entitled *Montana Taxation*.<sup>50</sup> While individual income tax was only a small piece of the study, the Council addressed the fact that Montana encourages married filing separately. The report states:

The Montana tax rates vary from 1.1 percent of the first \$1,000 of taxable income to 7.9 percent of income over \$7,000. Although the federal tax allows married couples to file joint returns and take advantage of tax brackets twice as wide as single taxpayers, Montana law allows no such provision. Montana law allows separate filing of wife and husband if they both earn income.<sup>51</sup>

Additionally, the report made the following recommendation:

Currently, if a wife earns income, she may file a return separate from her husband. There is a major problem in auditing these returns. The two returns must be together to properly audit them and this is difficult to accomplish. Taxpayers are never sure how to allocate income, deductions and exemptions between returns. Also, there are a large number of taxpayers, especially in low income groups, who unknowingly do not take advantage of filing separate returns.

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<sup>48</sup> Minutes of the Senate Taxation Committee, p. 1 (12:00 p.m. Jan. 24, 1963). The minutes state that Senate Bill No. 102 “was also discussed by Senator Brenner, the author of the bill.” The nature of the discussion is not contained in the minutes, but a “Do Pass” motion carried unanimously.

<sup>49</sup> Minutes of the House Ways and Means Committee, pp. 1-2 (9:00 a.m. Feb. 27, 1963).

<sup>50</sup> *Montana Taxation, A Report to the Fortieth Legislative Assembly*, Montana Legislative Council, Report No. 23 (Dec. 1966).

<sup>51</sup> *Id.* at 47.

There are two main alternatives for solution to these problems: (1) make some provision for income splitting; or (2) eliminate the provision allowing separate filing in our income tax law. The Task Force recommends that the provision for separate filing be eliminated. The additional revenue forthcoming from this change would be about \$3 to \$5 million per year.<sup>52</sup>

Based on the Council report, it is clear that married filing separately was very common. However, it is also clear that the Board had not created a form that allowed married couples to file separately on the same form.

**v. 1973 – 1976: The Department of Revenue and the 1976 Subcommittee on Taxation Study**

“Following the adoption of the new Montana Constitution in 1972, the Forty-Third Legislative Assembly abolished the three member State Board of Equalization and established a reorganized State Department of Revenue.”<sup>53</sup> As such, in 1973 the Legislature changed all statutory references from the Board to the Department of Revenue (DOR).<sup>54</sup>

A review of the DOR’s historical tax records confirmed that the modern tax return that allows a husband and wife to file separately on the same form did not come into existence until 1972.<sup>55</sup> The adoption of this form did not require a change in substantive law, but it was a very popular option.<sup>56</sup> Presumably, this change made it much easier to audit returns.

In 1976, the Subcommittee on Taxation undertook a study to investigate the gross income tax, in addition to studying the “‘income splitting’ problem - - the effects of Montana’s single set of rates and incentive to file separately upon married taxpayers with one source of income.”<sup>57</sup> A meeting was held on April 23, 1976, and the DOR was asked “to draw up alternative sets of rates tables which would favor joint husband-wife returns”.<sup>58</sup> The subcommittee deliberations on this issue were summarized as follows in the report:

The second major area which the subcommittee was directed to consider was income-splitting between husband and wife. Unlike the Internal Revenue Code with its four sets of rates (married-joint, married-filing separately, single-head of household, and single), the

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<sup>52</sup> *Id.* at 76.

<sup>53</sup> *Report of the State Department of Revenue to the Governor and Members of the Forty-fourth Legislative Assembly of the State of Montana for the Period July 1, 1972 to June 30, 1974*, William A. Groff, Acting Director, p. 1 (1974).

<sup>54</sup> *See* Secs. 1 – 256, Ch. 516, L. 1973.

<sup>55</sup> The first sentence in the instructions for the 1972 Montana Individual Income Tax Return provides: “The 1972 return form has been redesigned to permit husbands and wives who desire the file separately to do so using only one return form.”

<sup>56</sup> A 1976 interim study by the subcommittee on taxation shows that out of 118,714 married filing separate returns, 112,676 were married filing separate on the same form, 3,691 were separate on different forms, and 2,347 were separate with one spouse not filing. *See Montana’s State Income Tax, A Report to the Forty-Fifth Legislature*, Interim Study by the Subcommittee on Taxation, App. B (Dec. 1976).

<sup>57</sup> *Id.* at 3.

<sup>58</sup> *Id.* at 5.

state income tax has but one set of rates for all taxpayers. Since the tax bill on \$20,000 of taxable income is \$1,439, while the bill for \$10,000 taxable income is \$539, a husband and wife who each earn \$10,000 taxable income will always file separate state returns -- they save \$407 over what they would owe on a joint return on \$20,000.

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The subcommittee requested the department of revenue to draw up sets of rate schedules to make filing the joint return more advantageous for married taxpayers. The department went through five sets and found that one or another of the following problems always appeared:

- (1) If we keep single taxpayers' liability where it is now and cut the married-filing-jointly rate until it is advantageous for nearly all couples, the revenue loss to the state is too large (\$8 million to \$11 million per year);
- (2) If we design an advantageous joint rate within the limits of a modest revenue loss (\$3 million to \$4 million) the taxes of single persons generally have to go up;
- (3) If we go to simple income-splitting for joint returns relative to single returns, the rate differential, like the federal rates from 1948 to 1971, discriminates against single persons;
- (4) If we follow the rate relationships of the current federal tables, where the second table sets significantly higher rates for marrieds-filing-separately (with rates for singles falling in between), and avoid the major revenue loss, taxes will go up for many married taxpayers in Montana with separate incomes.

In short, there appears to be no way to move from where we are to another position without either increasing taxes on some groups or incurring substantial revenue loss. The subcommittee therefore makes no recommendation for adopting a joint return rate schedule.

<sup>59</sup>

**vi. 1983 – 1985: Married Filing Separately on the “Same Form”  
Recognized in Statute for Child and Dependent Care Expenses**

In 1983, House Bill No. 125 sought to eliminate the requirement that a joint income tax return must be filed by a married individual when claiming a deduction for child and

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<sup>59</sup> *Id.* at 11-12.

dependent care expenses.<sup>60</sup> The minutes of the House Taxation Committee show that no one opposed the bill, while proponents testified that the bill would correct a marriage penalty problem.<sup>61</sup> That is, Montana families with both parents working were not filing joint returns to claim child care expenses due to the fact that the rate of tax went up with a joint return. The Director of the DOR stated that the agency's concern with the bill was from "an administrative point of view."<sup>62</sup> The Director suggested that language should be inserted stating "if separate filing taxpayers are allowed this deduction, they must file separately on the same form."<sup>63</sup> An amendment was made to the bill that contained the "same form" language and it sailed through the House without any negative votes.<sup>64</sup> Moreover, the Senate Taxation Committee voted that the bill be concurred in, and it passed the Senate with only two negative votes.<sup>65</sup> The bill was signed into law by the Governor, and the ability to file married filing separately on the "same form" was officially codified in the statute at section 15-30-121(3)(b), MCA (current version at section 15-30-2131, MCA). Two years later the "same form" language was retained when the same statute was amended by Senate Bill No. 436, but it was not deemed a substantive change to the law, and there were no discussions concerning the additional language in the minutes.<sup>66</sup>

#### **vii. 1992 Special Session: Married Filing Separately on the "Same Form" Recognized in Statute for Estimated Tax Payments**

In the January 1992 Special Session, House Bill No. 14 sought revenue by requiring estimated individual income tax payments to be made in four installments and through employer withholdings.<sup>67</sup> A small part of the bill provided that the penalty for failing to withhold was computed differently for married individuals filing separately on the "same form".<sup>68</sup> The bill stated that when married couples file separately on the same form they must compute a "failure to properly withhold" penalty based on the combined tax liability and combined credits and withholdings.<sup>69</sup> This was beneficial when one spouse owed tax and the other overpaid, since the penalty was based on the unpaid tax after applying the overpayment from the other spouse. The bill was introduced on January 7, 1992, and it was signed into law by Governor Stephens on February 4, 1992.

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<sup>60</sup> See Ch. 118, L. 1983 (current version at section 15-30-1231, MCA).

<sup>61</sup> Minutes of the House Taxation Committee, p. 2 (8:00 a.m. Jan. 11, 1983).

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> Minutes of the House Taxation Committee, p. 5-6 (Jan. 13, 1983); History and Final Status of Bills and Resolutions of the Senate and House of Representatives of the State of Montana, Forty-Eighth Legislature, p. 46 (1983).

<sup>65</sup> Minutes of the Senate Taxation Committee, p. 6 (March 4, 1983); History and Final Status of Bills and Resolutions of the Senate and House of Representatives of the State of Montana, Forty-Eighth Legislature, p. 46 (1983).

<sup>66</sup> See Sec. 1, Ch. 613, L. 1985 (current version at section 15-30-2131, MCA); Minutes of the Senate Taxation Committee, pp. 1-2 (Feb. 27, 1985) ("Senator Towe asked if there was a substantive change in the law. Mr. Hall [of the DOR] said, no, that the reason for the extensive changes in the bill were that formerly the Montana law had referred to federal code and that was no longer possible."); Minutes of the Senate Taxation Committee, p. 4 (Mar. 11, 1985); Minutes of the House Taxation Committee, p. 8 (Mar. 27, 1985).

<sup>67</sup> See Sec. 1, Ch. 17, Sp. L. Jan. 1992 (amending section 15-30-241, MCA (current version at section 15-30-2512, MCA)).

<sup>68</sup> See *id.* (amending section 15-30-241, MCA (current version at section 15-30-2512(5)(d), MCA)).

<sup>69</sup> *Id.*

**viii. 2007: Married Filing Separately on the “Same Form” Recognized in Statute for Adoption Tax Credit**

In 2007, House Bill No. 490 was introduced to allow a tax credit equal to \$1,000 for legal adoptions that occurred on or after January 1, 2007.<sup>70</sup> The bill initially provided that married taxpayers filing separately on the same “return” could allocate the credit between the spouses. However, this language was amended to filing separately on the same “form”, as technically two returns are being filed when a married couple uses one form to file separately, as pointed out by the fiscal note.<sup>71</sup> There was no discussion in either the House Committee on Taxation or the Senate Committee on Taxation regarding the language change.<sup>72</sup> However, the purpose of the bill was to offset the fact that couples who adopted children and claimed the federal adoption tax credit actually saw an increase in Montana taxes due to the credit at the federal level. The bill easily passed the House and the Senate, and it was signed into law by Governor Schweitzer on April 28, 2007.

**ix. Montana’s Current Rate Structure Encourages Most Married Couples to File Separately on the Same Form**

As it stands, Montana uses a single rate structure for all taxpayers, regardless of filing status.<sup>73</sup> The rate structure is modified by the DOR on a yearly basis by the inflation factor for the tax year, as rounded to the nearest \$100.<sup>74</sup> Montana’s income tax rates for tax year 2009 are as follows:

Rate Table			
If your taxable income is			
More than	But not more than	Then your tax is	Less
\$0	\$2,600	1% of taxable income	
\$2,600	\$4,500	2% of taxable income	\$26
\$4,500	\$6,900	3% of taxable income	\$71
\$6,900	\$9,300	4% of taxable income	\$140
\$9,300	\$12,000	5% of taxable income	\$233
\$12,000	\$15,400	6% of taxable income	\$353
More than \$15,400		6.9% of taxable income	\$492

If a couple files a joint return, the rate table applies to the couple’s combined taxable income. However, if the couple files separate returns, then each spouse is able to use the rate table. In most cases, two-earner couples filing separate state returns will have a lower overall tax bill, but there are exceptions to the rule. These exceptions generally come into play when one couple is in a very low tax bracket. For example, a September 18, 2009, DOR memo<sup>75</sup> provided two examples where a couple would have had lower overall tax

<sup>70</sup> Ch. 320, L. 2007 (now codified at section 15-30-2364, MCA).

<sup>71</sup> *Fiscal Note 2009 Biennium: HB 490*, p. 3 (Feb. 6, 2007).

<sup>72</sup> Minutes of the House Committee on Taxation (Feb. 2, 2007); Minutes of the House Committee on Taxation (Feb. 9, 2007); Minutes of the Senate Committee on Taxation (Mar. 15, 2007); Minutes of the Senate Committee on Taxation (Apr. 9, 2007).

<sup>73</sup> See section 15-30-2103, MCA.

<sup>74</sup> *Id.* Montana’s inflation factor was enacted by initiative in 1980. Sec. 2, I.M. No. 86, approved Nov. 4, 1980.

<sup>75</sup> Memorandum from Dan Dodds, Tax Policy Analyst, to Dan Bucks, Director of the Mont. Dept. of Rev., at 6-7 (Sept. 18, 2009) (hereinafter “DOR Memo 1”), available at [http://revenue.mt.gov/revenue/publications/reports/legislative\\_interim\\_committees/9-09/married\\_filing\\_separately.pdf](http://revenue.mt.gov/revenue/publications/reports/legislative_interim_committees/9-09/married_filing_separately.pdf) (last visited Jan. 27, 2010).

liabilities by filing joint returns. When one spouse had \$2,000 in adjusted gross income (AGI), and the other spouse had \$38,000 in AGI, the couple saved \$285 by filing jointly. Additionally, when one spouse had \$6,000 in AGI, and the other spouse had \$54,000 in AGI, the couple saved \$23 by filing jointly.

More than 55 percent of married couples in Montana file separate state income tax returns.<sup>76</sup> Yet, less than 3% of couples file separate returns at the federal level.<sup>77</sup> As such, one can speculate that 52% (55% - 3% federal average) of the couples filed separately in the hopes of having a lower tax liability, while 3% may have filed separately for nontax reasons. For example, spouses who keep their finances separate may choose to file separately to avoid joint and several liability.<sup>78</sup> Otherwise, one spouse could be on the hook for the other spouse's failure to properly report income and deductions.

In a December 2, 2009, DOR memo,<sup>79</sup> 2,548 couples were identified who may have paid more money by filing separately, half of which had an extra tax of only \$20 or less.<sup>80</sup> Of these 2,548 couples, the DOR assumed that some couples were trying to keep their finances separate, some couples had a long-term tax strategy, and some couples did not understand how the \$5,000 cap on federal tax deductions is increased to a \$10,000 cap when a joint return is filed.<sup>81</sup> Perhaps the most disconcerting DOR finding was the fact that many retired couples with pension income would have had lower taxable income with a joint return.<sup>82</sup> Part of this is due to complexities regarding the \$3,600 exemption in section 15-30-2110(2)(c), MCA, for pension and annuity income, which phases out when federal AGI is between \$30,000 and \$33,600.<sup>83</sup> As it stands, the phaseout is not increased to \$60,000 when couples file jointly.<sup>84</sup> Consequently, retired couples understandably hypothesize that separate returns will result in lower taxes. However, by trying to obtain the pension exemption, some couples are not obtaining the full value of their standard deductions and allowable exemptions.<sup>85</sup> The only true way to avoid this pitfall is when tax returns are prepared both ways. However, some retired couples certainly gain a tax advantage by filing separately. For example, if two retired spouses with pension income each have \$30,000 in federal AGI, then they would lose \$7,200 in pension exemptions by filing jointly. As such, if the Legislature decides to change the law to encourage joint filing, then it should also consider an increase in the pension exemption phaseout.

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<sup>76</sup> *Id.* at 1.

<sup>77</sup> See Internal Revenue Service, Statistics and Income Division, *Tax Statistics: Table 1.2 All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2007*, available at: <http://www.irs.gov/pub/irs-soi/07in12ms.xls>.

<sup>78</sup> See section 15-30-2602(2), MCA.

<sup>79</sup> Memorandum from Dan Dodds, Senior Economist, to Dan Bucks, Director of the Mont. Dept. of Rev. (Dec. 3, 2009) (hereinafter "DOR Memo 2").

<sup>80</sup> *Id.* at 1.

<sup>81</sup> See *id.*

<sup>82</sup> *Id.* at 3, 6.

<sup>83</sup> *Id.* at 5-6.

<sup>84</sup> Section 15-30-2110(2)(c)(ii)(B), MCA.

<sup>85</sup> DOR Memo 2, *supra* note 79, at 6.

### c. State Survey: Filing Options in States With an Income Tax

In January 2009, the Wisconsin Legislative Fiscal Bureau (WLFB) conducted a survey of individual income tax provisions in the states.<sup>86</sup> The survey identified three types of filing systems in 44 states and the District of Columbia. The following is a summary of the survey, as reproduced by the WLFB:

Three types of filing systems were used by states in 2007, including joint, combined, or a combination of joint/combined. Under a joint filing system, the incomes of both spouses are added together and taxed as a single amount. This system is also used for federal tax purposes and reflects the concept of taxing families as a single economic unit. Under the combined tax return system, the income of each spouse is taxed separately. For two-income families, this system allows each spouse to benefit from the low tax rates at the beginning of the tax rate schedule. Finally, several states provide an option for married taxpayers to file either a joint or combined return. Instruction booklets in these states generally explain the tax advantage to two-income families under combined filing and encourage taxpayers to compute their taxes each way to determine which is most advantageous to the taxpayer.

The types of filing systems used by states in 2007 are as follows:

Combined Filing--two states (Missouri and Pennsylvania).

Joint/Combined Filing--seven states (Arkansas, Delaware, D.C., Iowa, Kentucky, Mississippi, Montana).

Joint Filing--35 states (all other states).

In addition, four states (California, Connecticut, New Jersey, and Vermont) plus the District of Columbia treat registered domestic partners or civil union partners in the same manner as spouses for income tax filing purposes. Such partners may choose to file either joint or separate returns.<sup>87</sup>

Based on the data from the survey,<sup>88</sup> Montana is only one of seven states that encourages married taxpayers to file separate returns. It is therefore helpful to see how the other states set up brackets for single, married filing jointly, married filing separately, and head of household taxpayers. There are wide variations among the states. Some states have systems that result in the marriage tax penalty, while the majority of states do not impose

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<sup>86</sup> Permission to reproduce this survey was granted to the Montana Legislative Services Division by the WLFB on January 7, 2010. As such, Table 6 of the WLFB survey is attached to this report as the appendix. Please contact WLFB if you desire to photocopy and/or reproduce the WLFB survey.

<sup>87</sup> Rob Reinhardt, Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States*, at 2 (Jan. 2009).

<sup>88</sup> See Appendix.

a marriage tax penalty. Moreover, some states provide an advantage for head of household filing while other states provide no such advantage. The following observations can be extracted from the survey:

- **Marriage Tax Penalty:** Nine states (Georgia, Minnesota, New Mexico, North Carolina, North Dakota,<sup>89</sup> Rhode Island, Vermont, West Virginia, and Wisconsin) tax married individuals filing separate returns at a higher rate than single individuals. As such, it could be argued that these states have a marriage tax penalty.

Five states (Maryland, New Jersey, Ohio, South Carolina, and Virginia) are classified as joint income tax states, but either one rate table is used for all return types or the highest marginal tax rate is the same for all return types. As such, a marriage tax penalty exists in these states if a joint return is required, but a marriage tax penalty does not exist if separate returns are allowed; married individuals may not be allowed to file separate returns and take advantage of two brackets. Further research would need to be conducted on a state-by-state basis to determine if a marriage tax penalty exists in these states.

- **No Marriage Tax Penalty:** Fourteen states (Alabama, Arizona, California, Connecticut, Hawaii, Idaho, Kansas, Louisiana, Maine, Nebraska, New York, Oklahoma, Oregon, and Utah<sup>90</sup>) with a progressive rate (*i.e.*, no flat tax) and a joint filing system (*i.e.*, not a combined system like Montana) tax married individuals filing separate returns at the same rate as single individuals. As such, it can be argued that these states do not have a marriage tax penalty.

Seven states (Arkansas, Delaware, D.C., Iowa, Kentucky, Mississippi, and *Montana*) allow individuals to choose the between filing jointly and married filing separately, but there is no apparent rate advantage to married filing jointly. Additionally, two states (Missouri and Pennsylvania) require combined separate filing. Since a married individual can use the same rate table as a single individual, it can be argued that these states do not have a marriage tax penalty.

Seven states (Colorado, Illinois, Indiana, Michigan, Massachusetts<sup>91</sup>, New Hampshire, Pennsylvania, and Tennessee) have a flat tax rate, regardless of the amount of taxable income or family status. Under the flat tax system, filing status alone does not provide a rate table benefit, so it can be argued that these states do not have a marriage tax penalty.

- **Head of Household Rates:** Fifteen states (Arizona, California, Connecticut, Georgia, Hawaii, Idaho, Maine, Minnesota, Nebraska, New Mexico, New York, North Carolina, Oklahoma, Oregon, and Utah) tax individuals that qualify as head

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<sup>89</sup> North Dakota has a standard method that imposes a marriage tax penalty, and an optional method. According to the WLFBS study, 97% of tax filers in North Dakota use the standard method.

<sup>90</sup> Utah also has an alternative single rate tax.

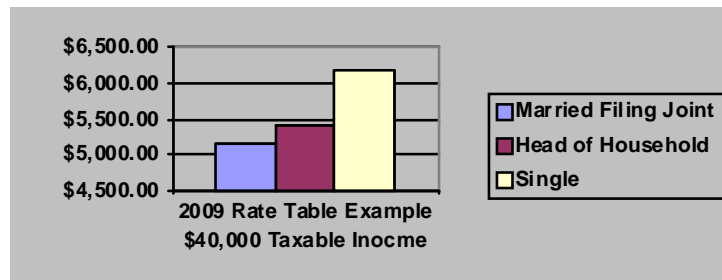
<sup>91</sup> Massachusetts has a modified flat tax system that taxes certain capital gains differently.



of the household (HH) at a lower marginal rate than single individuals. As such, these states follow the federal system by rewarding single individuals with dependents. However, the extent of the HH reward varies among the states. In seven states (Arizona, Georgia, Idaho, New Mexico, Oklahoma, Oregon, and Utah) the reward is high, and the HH taxpayer uses the same brackets as a married filing joint return. In the other eight states the HH rate is somewhere between what a single person would pay and what a couple filing a married filing joint return would pay. A review of the example below shows how the reward works at the federal level.

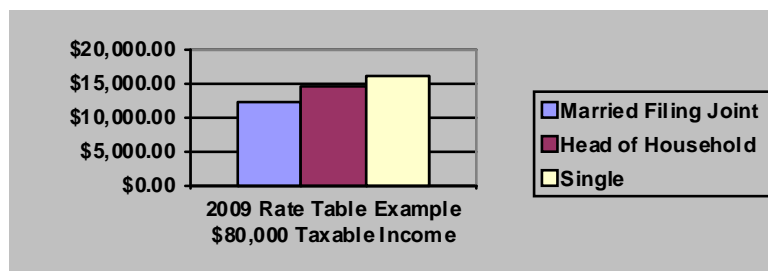
- The federal system is generally designed to tax single caregivers somewhere between what a single person and a married couple would pay with the same amount of taxable income. For example, assume that a married couple has \$40,000 in taxable income. Assume further that two single taxpayers each have \$40,000 taxable income, and one of the single taxpayers can claim HH. Using the 2009 federal rate tables, these returns would be taxed as follows:

Married Filing Joint Return:	\$ 5,169
Head of Household:	\$ 5,406
Single:	\$ 6,194



Consequently, the single caregiver receives a \$788 tax advantage by using the HH bracket. This tax advantage decreases when taxable income goes up. For example, if the married couple and each of the single individuals earn \$80,000 in taxable income, then the returns would be taxed as follows:

Married Filing Joint Return:	\$ 12,381
Head of Household:	\$ 14,859
Single:	\$ 16,194



One observation that can be made is that when taxable income increases, the person who files HH pays an amount that is near the middle of the married filing joint return and the single return.<sup>92</sup> Hence, a simple bracket would charge tax for HH at a rate that is exactly between what a single person would pay and what a married couple would pay. A more complex system would give larger advantages to HH taxpayers with lower incomes, which is present in the first example.

The state survey shows that a wide variety of options exist. However, some states have a complex tax structure with highly progressive rates in comparison to Montana. For example, New Jersey's highest marginal rate does not kick in until taxable income reaches \$500,000. Consequently, this synopsis of the WLFB survey should be used only for generalities, while the WLFB survey as a whole provides much more detail, and it is available upon request.

## **2. BENEFITS AND DRAWBACKS OF REVISING MONTANA'S METHOD FOR FILING INDIVIDUAL INCOME TAX RETURNS, INCLUDING AN ANALYSIS OF CHANGES TO RATE SCHEDULES**

The Department of Revenue (DOR) has identified four ways to restructure Montana income tax brackets so that more people would file joint returns. The options are as follows:

- a) Change state law so that married couples must file the same as on their federal return with the current rate table.
- b) Create a new rate table for joint returns that makes tax from a joint return the same as tax from two separate returns.
- c) Create a new rate table for married filing separate returns that makes tax from two married filing separate returns the same as tax from a joint return.
- d) Create new rate tables for all return types that makes tax from married filing separate and married filing joint returns the same.

For the purposes of this report, the above options are summarized in the order in which they are listed. Additionally, hypothetical rate tables are presented, as well as potential benefits and drawbacks for each option.

### **a. Requiring Married Taxpayers to File Their State Return Using the Same Status as Their Federal Return**

The Legislature could require taxpayers to file the same way for state purposes as they did for federal purposes. If such a change were implemented, the rate table could remain

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<sup>92</sup> This example ignores the fact that the person using the head of household status was able to lower taxable income by claiming the dependents as an exemption, which lowers the effective rate of tax.

the same. Additionally, most taxpayers with two incomes would pay more tax under this option, unless they decided to file separate federal returns. The DOR was unable to project how much revenue this change would add to the general fund, as it is impossible to know how many taxpayers would change the way they file their federal returns. The following are some of the advantages and disadvantages to this option:

Advantages:

- This would increase general fund revenue for the state.
- No change in rate brackets would be required.
- The percentage of taxpayers who file separate returns would decrease, as more people would file joint returns.

Disadvantages:

- It is hard to forecast how much of a positive impact in general fund revenue this would create.
- This change could add complexity to tax return preparation, as some taxpayers would prepare federal and state returns both ways in order to see which option nets the most in savings, which in turn would increase tax preparation expenses.
  - Revenue could go down sharply if taxpayers started filing their federal returns separately.
- Some spouses could be subjected to joint and several liability if they are required to file a joint return with the other spouse.
  - This could create more work for the DOR if more spouses request innocent spouse relief under section 15-30-2646, MCA.
- Some retired couples would decide to file separate federal returns in order to take advantage of the \$3,600 pension and annuity income exemption at the state level, which phases out when federal AGI hits \$30,000.
  - A remedy of this issue is possible if section 15-30-2110(2)(c), MCA, is amended by increasing the phaseout from \$30,000 federal AGI to \$60,000 federal AGI for joint filers.
- If one spouse is a resident of Montana and the other spouse is a resident of another state with no Montana source income, then a complexity exists.
  - California requires taxpayers to use the same filing status on the California return as the one used on the federal return, with two exceptions:<sup>93</sup>
    - 1) One spouse was an active duty military member; or
    - 2) One spouse was a nonresident for the entire year and had no income from California sources during the year.

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<sup>93</sup> See State of California – Franchise Tax Board, *Guidelines for Filing Separate Returns*, FTB Pub. 1051A (Rev. 10-2004).

- The federal Military Spouses Residency Relief Act, signed into law on Veterans Day 2009, allows a military service member’s spouse to keep his or her tax domicile throughout the marriage.
- If taxpayers are required to use the same filing status as the federal return, then the Legislature should consider an exemption of this requirement for nonresidents with no Montana source income. Additionally, the Legislature may desire to pursue legislation that complies with the federal Military Spouses Residency Relief Act.

**b. Creating a New Rate Table for Joint Returns That Makes Tax From a Joint Return the Same as Tax From Two Separate Returns**

The Legislature could create a new rate table for married taxpayers with rate brackets that are twice as wide as the rate brackets for other taxpayers. This would eliminate the incentive for most married couples to file separate Montana returns. If such a change were implemented, the current rate table would be doubled in size for married couples who decide to file jointly, which essentially encourages most individuals who file separately to file jointly. Additionally, individuals who currently file jointly, despite the fact that separate returns may be more favorable to them, will generally pay less tax. Since more people will have a lower tax liability, the DOR projected a reduction in general fund revenue of approximately \$40 million in tax year 2012 and \$41 million in tax year 2013.

Similar to the current rate table, new rate tables should be adjusted for inflation. If this change were made to current law, then the rate tables for tax year 2009 would be structured as follows:

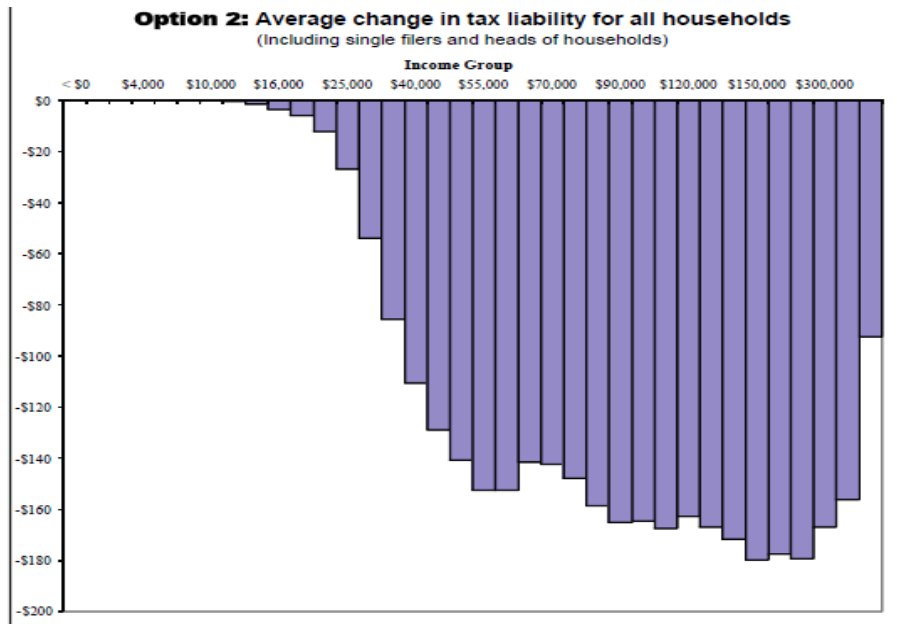
<b>2009 Single, Married Filing Separately, and Head of Household Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$2,600	1% of taxable income	
\$2,600	\$4,500	2% of taxable income	\$26
\$4,500	\$6,900	3% of taxable income	\$71
\$6,900	\$9,300	4% of taxable income	\$140
\$9,300	\$12,000	5% of taxable income	\$233
\$12,000	\$15,400	6% of taxable income	\$353
\$15,400 +	Unlimited	6.9% of taxable income	\$492

<b>Hypothetical 2009 Married Filing Jointly Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$5,200	1% of taxable income	
\$5,200	\$9,000	2% of taxable income	\$52
\$9,000	\$13,800	3% of taxable income	\$142
\$13,800	\$18,600	4% of taxable income	\$280
\$18,600	\$24,000	5% of taxable income	\$466
\$24,000	\$30,800	6% of taxable income	\$706
\$30,800 +	Unlimited	6.9% of taxable income	\$984

The following are some of the advantages and disadvantages to this option:

Advantages:

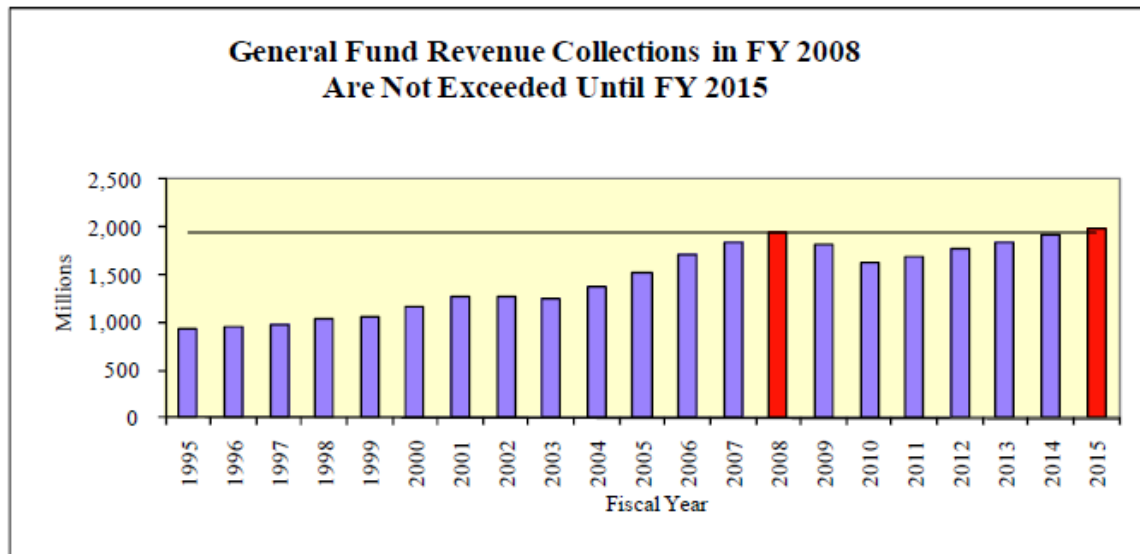
- This option would eliminate the incentive for most taxpayers to file separate returns.
- This option could save married taxpayers money in tax return preparation fees, as preparing returns both ways would rarely result in a lower tax liability.
- This option would be an advantage for married taxpayers who typically file joint returns, as they will have a lower tax liability (this also decreases state revenue, which is a disadvantage for the state).
  - The average decrease in tax liability is between \$140 and \$180 for income groups between \$45,000 and \$300,000.



Source: DOR Memo 1, *supra* note 75, at 12 (figure 3).

Disadvantages:

- This option would decrease general fund revenue by approximately \$40 million in 2012 and \$41 million in 2013.
  - According to revenue collection estimates from the Legislative Fiscal Division dated January 27, 2010, general fund revenue collections are down and will not reach FY 2008 levels again until FY 2015 (assuming the brackets are not changed to be twice as wide for married filing joint returns).



Source: LFD Revenue Collection Forecast dated January 27, 2010.

- According to a DOR study, a small percentage of households pay more under this option.
- Single taxpayers may claim that married taxpayers receive an unfair disadvantage.
- Some spouses could be subjected to joint and several liability if they elect to file a joint return with the other spouse.
  - This could create more work for the DOR if more spouses request innocent spouse relief under section 15-30-2646, MCA.
- Some retired couples would still decide to file separate Montana income tax returns in order to take advantage of the \$3,600 pension and annuity income exemption at the state level, which phases out when federal AGI hits \$30,000.
  - A remedy of this issue is possible if section 15-30-2110(2)(c), MCA, is amended by increasing the phaseout

from \$30,000 federal AGI to \$60,000 federal AGI for joint filers.

*Other Issues to Consider:*

- Under current law, two-income married couples may pay lower taxes than a single-income married couple if a two-income married couple files separate returns in order to take advantage of two rate tables. However, in the case of a single-income married couple, only one rate table will be used. If the rate tables are made twice as wide for married individuals, then a single-income married couple will have a lower tax liability. This is the system that was adopted at the federal level in 1948 and remains in place today.
  - Is such a system more or less fair from a policy perspective?
- Taxpayers who are allowed to file using a head of household filing status may eventually ask for legislation to create a new rate table that is somewhere between the single rate table and the married filing jointly rate table. From a policy perspective, this would give more tax benefits to taxpayers when they provided a home for dependents, which is a system that has been in place at the federal level since 1952. However, from a fiscal standpoint the general fund would be negatively impacted if a head of household table is created.

**c. Creating a New Rate Table for Married Filing Separate Returns That Makes Tax From Two Married Filing Separate Returns the Same as Tax From a Joint Return**

The Legislature could create a new rate table for married taxpayers who file separate returns with brackets that are half as wide as the current rate table. This would take away the incentive to file separate returns, and ultimately increase taxes for most married couples who file separately under current law. Since more people would pay higher taxes, the DOR projected this bracket change would increase general fund revenue by approximately \$38 million in tax year 2012 and \$39 million in tax year 2013.

Similar to the current rate table, future rate tables should be adjusted for inflation. If this change were currently in place, then the rate tables for tax year 2009 would be structured as follows:

<b>2009 Single, Married Filing Jointly, and Head of Household Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$2,600	1% of taxable income	
\$2,600	\$4,500	2% of taxable income	\$26
\$4,500	\$6,900	3% of taxable income	\$71
\$6,900	\$9,300	4% of taxable income	\$140
\$9,300	\$12,000	5% of taxable income	\$233
\$12,000	\$15,400	6% of taxable income	\$353
\$15,400 +	Unlimited	6.9% of taxable income	\$492

<b>Hypothetical 2009 Married Filing Separate Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$1,300	1% of taxable income	
\$1,300	\$2,250	2% of taxable income	\$13
\$2,250	\$3,450	3% of taxable income	\$36
\$3,450	\$4,650	4% of taxable income	\$70
\$4,650	\$6,000	5% of taxable income	\$117
\$6,000	\$7,700	6% of taxable income	\$177
\$7,700 +	Unlimited	6.9% of taxable income	\$246

*Advantages:*

- This option would eliminate the incentive for most taxpayers to file separate returns.
- This option could save taxpayers money in tax return preparation fees, as few people would prepare taxes both ways.
- This option would increase general fund revenue by approximately \$38 million in tax year 2012 and \$39 million in tax year 2013.
- Very few households with total household income of \$20,000 or less would pay at least 2% more in tax.<sup>94</sup>

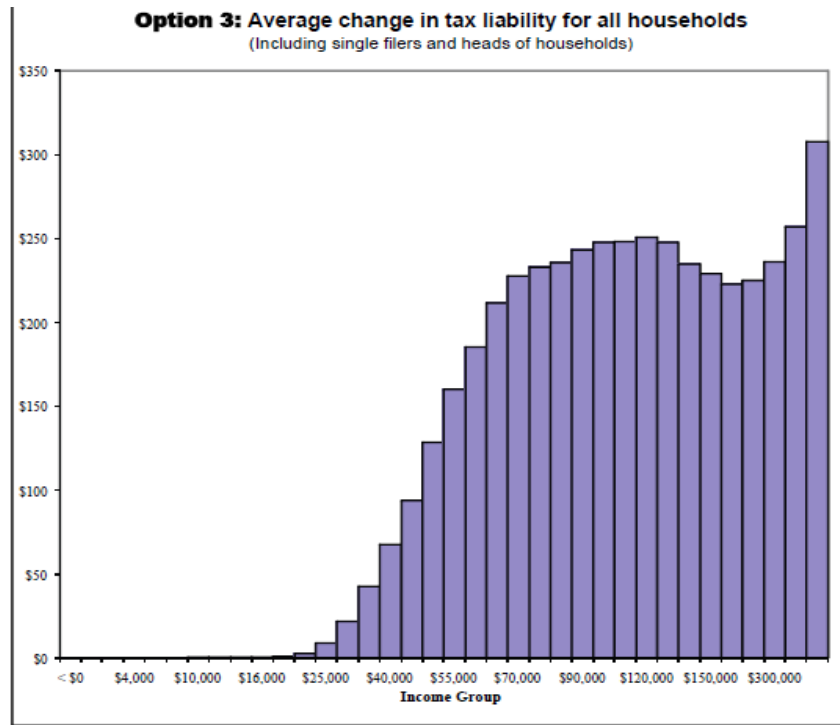
*Disadvantages:*

- The average increase in tax liability is approximately \$70 when a couple has \$40,000 in total household income and approximately \$250 when a couple has \$120,000 in total household income.<sup>95</sup>

<sup>94</sup> DOR Memo 1, *supra* note 75, at 13-14 (figure 4).

<sup>95</sup> *Id.* at 14 (figure 5).





Source: DOR Memo 1, *supra* note 75, at 14 (figure 5).

- This option increases taxes for most married couples who currently file separately.
- Some spouses could be subjected to joint and several liability if they elect to file a joint return with the other spouse.
  - This could create more work for the DOR if more spouses request innocent spouse relief under section 15-30-2646, MCA.
- Some retired couples may decide to file separate Montana income tax returns in order to take advantage of the \$3,600 pension and annuity income exemption at the state level, which phases out when federal AGI hits \$30,000.
  - A remedy of this issue is possible if section 15-30-2110(2)(c), MCA, is amended by increasing the phaseout from \$30,000 federal AGI to \$60,000 federal AGI for joint filers.

*Other Issues to Consider From a Policy Perspective:*

- Rate structure could be seen as a marriage tax penalty because a marital unit is taxed using the same bracket as a single individual. In other words, from a tax standpoint it may be more beneficial to stay single.

- Only one state (West Virginia) appears to use brackets for married taxpayers who file separate returns that are consistently half as wide as single rates. However, at least three states follow this approach for high-income (*i.e.*, \$349,701) couples, including North Dakota, Rhode Island, and Vermont.
- Under current law, two-income married couples may pay lower taxes than a couple with a single income if a two-income couple files separate returns in order to take advantage of two rate tables. However, in the case of a single-income couple, only one rate table will be used. If the rate tables are made half as wide for married individuals who file separately, then a single-income couple is essentially taxed the same as current law provides, while a two-income married couple could face higher taxes than under current law.
  - Is such a system more or less fair from a policy perspective?
- Does the potential reduced cost of preparing returns justify the tax increase?

**d. Creating Four New Rate Tables for All Filing Statuses That Makes Tax From Married Filing Separate Returns the Same as a Joint Return**

The Legislature could create rate tables for single, married filing jointly, married filing separately, and head of household. Such a system would be similar to that used by the federal government, but the rates could be designed to have a minimal general fund revenue impact. When developing a rate structure if the brackets for married filing separate returns are half as wide as the rate structure for married filing jointly, then generally the incentive to file separate returns goes away. However, various choices must be considered when developing the single and head of household rate structures. As stated above in section 1.c., at least nine states tax married individuals filing separate returns at a higher rate than single individuals, while fourteen states tax married individuals filing separate returns at the same rate as single individuals. Additionally, fifteen states tax individuals that qualify as head of the household (HH) at a lower marginal rate than single individuals. In seven states the reward is high, and the HH taxpayer uses the same brackets as a married filing joint return. In the other eight states the HH rate is somewhere between what a single taxpayer would pay and what a couple filing a married filing joint return would pay.

In a memo dated December 3, 2008,<sup>96</sup> the DOR created four rate tables that were designed to be close to revenue neutral. When designing a revenue-neutral system, there will be taxpayers who will have lower taxes and taxpayers who will have higher taxes.

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<sup>96</sup> Mont. Dept. of Rev. Memorandum from Dan Dodds, Tax Policy Analyst, to Ed Caplis, Tax Policy & Research Director (Dec. 3, 2008) (hereinafter “DOR Memo 3”).

Essentially, the taxpayers who face increased taxes are covering the taxpayers with lower taxes.

The DOR hypothetical rate tables for tax year 2009 were structured as follows:

<b>Hypothetical 2009 Single Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$2,300	2% of taxable income	\$0
\$2,300	\$4,700	3% of taxable income	\$23
\$4,700	\$8,300	4.9% of taxable income	\$112
\$8,300	\$14,300	5.5% of taxable income	\$162
\$14,300	\$20,900	6.5% of taxable income	\$305
\$20,900+	Unlimited	6.9% of taxable income	\$389

<b>Hypothetical 2009 Married Filing Joint Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$4,600	2% of taxable income	\$0
\$4,600	\$9,300	3% of taxable income	\$46
\$9,300	\$13,900	4.9% of taxable income	\$223
\$13,900	\$17,400	5.5% of taxable income	\$306
\$17,400	\$20,900	6.5% of taxable income	\$480
\$20,900	Unlimited	6.9% of taxable income	\$564

<b>Hypothetical 2009 Married Filing Separate Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$2,300	2% of taxable income	\$0
\$2,300	\$4,650	3% of taxable income	\$23
\$4,650	\$6,950	4.9% of taxable income	\$111
\$6,950	\$8,700	5.5% of taxable income	\$153
\$8,700	\$10,450	6.5% of taxable income	\$240
\$10,450	Unlimited	6.9% of taxable income	\$282

<b>Hypothetical 2009 Head of Household Rate Table</b>			
If your taxable income is			
<b>More than</b>	<b>But not more than</b>	<b>Then your tax is</b>	<b>Less</b>
\$0	\$3,300	2% of taxable income	\$0
\$3,300	\$6,200	3% of taxable income	\$33
\$6,200	\$11,900	4.9% of taxable income	\$151
\$11,900	\$15,800	5.5% of taxable income	\$222
\$15,800	\$20,900	6.5% of taxable income	\$380
\$20,900	Unlimited	6.9% of taxable income	\$464

In developing the rate tables, the DOR increased the maximum standard deduction and personal exemptions in an attempt to reduce the impact on low-income taxpayers.<sup>97</sup> Additionally, it was presumed that the Legislature would amend section 15-30-2110(2)(c), MCA, by increasing the pension exemption phaseout from \$30,000 federal AGI to \$60,000 federal AGI for joint filers.

Advantages:

- This option would eliminate the incentive for most taxpayers to file separate returns.
- This option could save taxpayers money in tax return preparation fees, since fewer people would prepare taxes both ways.
- This option would have minimal affect on general fund revenue.
  - The DOR projected a reduction in general fund revenue of about \$2 million if this change were in effect for tax year 2009 or 2010, but revenue loss grows over time.
- Overall, 25% of households would have a tax liability of at least 2% lower.<sup>98</sup>
- Overall, 24% of households would see a change in tax liability of less than 2%.<sup>99</sup>

Disadvantages:

- Overall, 51% of households would see an increase in tax liability of at least 2%.<sup>100</sup>
- This option creates a lot of winners and a lot of losers.
- Some spouses could be subjected to joint and several liability if they elect to file a joint return with the other spouse.

<sup>97</sup> The single or married filing separately standard deductions were set at a minimum of \$1,830 and a maximum of \$4,130; the joint or head of household standard deductions were set at a minimum of \$1,830 and a maximum of \$4,130; the personal exemption was increased to \$2,580.

<sup>98</sup> DOR Memo 3, *supra* note 96, at 6-7 (figure 3).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

- This could create more work for the DOR if more spouses request innocent spouse relief under section 15-30-2646, MCA.

Other Issues to Consider:

- Fifty-two percent of the reduction goes to taxpayers with incomes over \$500,000.
- Single taxpayers would see an increase in their average effective tax rates when they earn income of up to approximately \$40,000, but the effective rate is about the same as current law after \$40,000.
- The majority of couples who file jointly under current law would see a reduction in tax of at least 2%.
- Approximately 75% of married couples who file separately under current law would see an increase in tax liability of 2% or greater.
- Head of household filers would pay about the same as current law at incomes less than approximately \$20,000 and less than current law at higher incomes.
- The majority of couples who file as head of household under current law would see a reduction in tax of up to 2%.
- Rate structure could be seen as a marriage tax penalty, because a marital unit is taxed using a higher rate of tax than an unmarried couple. In other words, from a tax standpoint it could be more beneficial to stay single.
- Under current law, two-income married couples may pay lower taxes than a couple with a single-income if a two-income couple files separate returns in order to take advantage of two rate tables. However, in the case of a single-income couple, only one rate table will be used. If the married filing separate rate table is half as wide for married individuals who file separately, a single-income couple is essentially taxed the same as a two-income married couple. This is the system that was adopted at the federal level in 1948 and remains in place today.
  - Is such a system more or less fair from a policy perspective?
- Does the potential reduced cost of preparing returns justify the tax increase?

**Winners, Losers, and No Change – Based on 2007 Statistics**

Taxpayers with at least a 2% higher liability are losers.  
 Taxpayers with at least a 2% lower liability are winners.  
 Taxpayers with a liability increase or decrease of less than 2% are considered to have no change.

<b>Category</b>	<b>Winners</b>	<b>Losers</b>	<b>No Change</b>
Single	7.5%	65.1%	27.3%
Married Filing Joint Return	64.1%	4.5%	31.3%
Married, Separate Returns, Same Form	15%	73.2%	11.8%
Married, Separate Returns, Separate Forms	8.8%	76.4%	14.8%
Married, Separate Return Spouse Not Filing	30.7%	51.6%	17.7%
Head of Household	59.6%	21.1%	19.2%

Source: DOR Memo 3, *supra* note 96, at 9.

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## APPENDIX

Table 6: Tax Rates and Brackets by State (Tax Year 2007)

State	Marginal Tax Rates		Number of Brackets	Top Marginal Tax Rate Begins at:			
	Lowest Tax Rate	Top Tax Rate		Single Bracket	Married-J Bracket	Married-S Bracket	Head of HH Bracket
Alabama	2.0%	5.0%	3	\$3,001	\$6,001	\$3,001	\$3,001
Arizona	2.59	4.54	5	150,001	300,001	150,001	300,001
Arkansas <sup>a</sup>	1.0	7.0	6	31,000	31,000	31,000	31,000
California	1.0	9.3	6	44,815	89,629	44,815	61,001
Colorado	4.63	4.63	Flat Rate	---	---	---	---
Connecticut	3.0	5.0	2	10,001	20,001	10,001	16,001
Delaware	0.0	5.95	7	60,001	60,001	60,001	60,001
Dist. of Columbia	4.0	8.5	3	40,001	40,001	40,001	40,001
Georgia	1.0	6.0	6	7,001	10,001	5,001	10,001
Hawaii	1.4	8.25	9	48,001	96,001	48,001	72,001
Idaho	1.6	7.8	8	24,737	49,473	24,737	49,473
Illinois	3.0	3.0	Flat Rate	---	---	---	---
Indiana	3.4	3.4	Flat Rate	---	---	---	---
Iowa	0.36	8.98	9	60,436	60,436	60,436	60,436
Kansas	3.5	6.45	3	30,001	60,001	30,001	30,001
Kentucky	2.0	6.0	6	75,001	75,001	75,001	75,001
Louisiana	2.0	6.0	3	25,001	50,001	25,001	25,001
Maine	2.0	8.5	4	18,950	37,950	18,950	28,450
Maryland	2.0	4.75	4	3,001	3,001	3,001	3,001
Massachusetts <sup>b</sup>	5.3	12.0	Flat Rates	---	---	---	---
Michigan	4.01	4.01	Flat Rate	---	---	---	---
Minnesota	5.35	7.85	3	69,991	123,751	61,881	105,411
Mississippi	3.0	5.0	3	10,001	10,001	10,001	10,001
Missouri	1.5	6.0	10	9,001	9,001	9,001	9,001
Montana	1.0	6.9	7	14,901	14,901	14,901	14,901
Nebraska	2.56	6.84	4	27,001	54,001	27,001	40,001
New Hampshire	5.0	5.0	Flat Rate	---	---	---	---
New Jersey <sup>c</sup>	1.4	8.97	6/7	500,001	500,001	500,001	500,001
New Mexico	1.7	5.3	4	16,001	24,001	12,001	24,001
New York	4.0	6.85	5	20,001	40,001	20,001	30,001
North Carolina	6.0	8.0	4	120,001	200,001	100,001	160,001
North Dakota <sup>d</sup>	2.1	5.54	5	349,701	349,701	174,851	349,701
Ohio	0.649	6.555	9	200,001	200,001	200,001	200,001
Oklahoma	0.5	6.65	7	8,701	15,001	8,701	15,001
Oregon	5.0	9.0	3	7,151	14,301	7,151	14,301
Pennsylvania	3.07	3.07	Flat Rate	---	---	---	---
Rhode Island	3.75	9.9	5	349,701	349,701	174,851	349,701
South Carolina	0.0	7.0	6	12,651	12,651	12,651	12,651
Tennessee	6.0	6.0	Flat Rate	---	---	---	---
Utah <sup>e</sup>	2.3	7.0	6	5,001	11,001	5,001	11,001
Vermont	3.6	9.5	5	349,701	349,701	174,851	349,701
Virginia	2.0	5.75	4	17,001	17,001	17,001	17,001
West Virginia	3.0	6.5	5	60,000	60,000	30,000	60,000
Wisconsin	4.6	6.75	4	142,651	190,211	95,101	142,651

<sup>a</sup> Special tax table for low-income taxpayers.

<sup>b</sup> Massachusetts has flat tax rates, each of which is applied to different sources of income.

<sup>c</sup> Six rates for single and married-separate filers and seven rates for married-joint and head-of-household filers.

<sup>d</sup> North Dakota's standard method. There is also an optional method with separate rates and brackets.

<sup>e</sup> Utah also provides an alternative, single rate tax calculation at a flat tax rate of 5.35%.

SOURCE: Rob Reinhardt, Wisconsin Legislative Fiscal Bureau, *Individual Income Tax Provisions in the States* (Jan. 2009) (Table 6).