# Background Report on Montana's Individual Income Tax
For the Senate Joint Resolution No. 37 Study

Prepared for the Revenue and Transportation Interim Committee
by
Jeff Martin, Legislative Research Analyst
Legislative Services Division

September 2009

## INTRODUCTION

This report provides a brief overview or Montana's individual income tax structure, including conformity with federal income tax law and adjustments to arrive at Montana adjusted gross income. It also highlights some points related to allowing married taxpayers in Montana to file separately on the same form.

## CONFORMITY WITH FEDERAL INCOME TAX LAW

States that impose individual income taxes on their residents and on the net income of corporations generally follow the federal income tax base, including definitions of income, deductions, exemptions, and the tax treatment of various transactions. Conformance with federal income tax laws assists in the compliance with and administration of the state's income tax laws.

There are two ways that states conform with federal income tax laws: rolling conformity or fixed-date conformity. Rolling conformity means that a state is automatically tied to federal income tax law and to any changes in the law unless it specifically "decouples" from a federal provision. Montana is a rolling-conformity state. Fixed-date conformity means that a state is statutorily tied to federal income tax law as it read on a specific date; legislative action is required to change the date.

## FEDERAL BASE

Most states use federal adjusted gross income as the starting point for determining taxable income. Colorado imposes a flat rate on modified federal taxable income. Illinois, Indiana, and Michigan impose a flat tax on modified federal adjusted gross income. Rhode Island taxpayers may compute tax liability on the lesser of a graduated rate schedule (25% of the federal tax rate by taxable income bracket) or a flat rate on modified federal adjusted gross income.[1] New Hampshire and Tennessee tax only interest and dividend income.

Montana uses federal adjusted gross income as the starting point for determining state tax liability. Montana individual income tax is calculated by:[2]

---

[1]Previously Rhode Island based its tax on federal tax liability.

[2]Derived from *Biennial Report, July 1, 2004 to June 30, 2006*, Montana Department of Revenue, December 2006, p. 25.

1. Determining federal adjusted gross income (income from all sources, less federal adjustments to income)

2. Adding Montana additions and subtracting Montana subtractions to determine Montana adjusted gross income

3. Subtracting itemized deductions or the standard deduction and subtracting personal exemptions to determine Montana taxable income

4. Multiplying taxable income by the tax table rate to determine tax before credits

5. Subtracting credits to determine amount of tax due

**MONTANA ADJUSTMENTS**

Montana has adopted a variety of modifications, or additions and subtractions, to federal adjusted gross income in determining Montana adjusted gross income. Additions to income may include certain types of Montana income that is untaxed at the federal level, such as nonqualified withdrawals from certain Montana-specific savings accounts, or income that is exempt from federal taxation, such as interest on municipal bonds issued in another state.

The following is a partial list of items that are added to federal adjusted gross income (most, but not all the items listed below are included in 15-30-2110, MCA, formerly 15-30-111, MCA) in determining Montana adjusted gross income:

- interest received from obligations of another state or political subdivision of the other state (this interest in exempt from federal taxation);

- taxable federal refunds and other recoveries of amounts deducted in earlier years that reduced Montana taxable income (tax benefit rule);

- addition to federal taxable Social Security/Railroad Retirement;

- nonqualified withdrawals from medical care savings account and first-time home buyer savings account;

- dependent care assistance credit adjustment (addback to federal adjusted gross income for business expenses related to dependent care claimed on the federal return);

- credit for premiums for the Insure Montana Small Business Health Insurance Program

The following is a partial list of items that are subtracted from federal adjusted gross income, either because federal law does not allow the taxation of certain income or because Montana has provided a specific exclusion:

- interest from federal obligations (federal law prohibits state taxation);
- tribal income (federal law prohibits state taxation);
- unemployment benefits (excluded from the definition of "gross income" under 15-30-2101, MCA, formerly 15-30-101, MCA);
- workers' compensation benefits;
- state income tax refunds;
- military salary of residents on active duty (15-30-2117, MCA, formerly 15-30-116, MCA);
- military salary of nonresidents serving in Montana (excluded from the definition of "Montana source income" under 15-30-2101, MCA, formerly 15-30-101, MCA. Federal law prohibits the state taxation of nonresident military pay);
- partial pension and annuity exemption (enacted in response to Davis v. Michigan dealing with state income taxation of federal retirees);
- partial interest exemption for taxpayers 65 years of age and older ($800 separate return, $1,600 joint return)
- exemption for certain taxed tips and gratuities (for services rendered to patrons of establishments licensed to provide food, beverages or lodging).
- exempt deposits and earnings in a medical care savings account, first-time home buyers savings account, or family education savings account.

**LEGISLATION TO DECOUPLE FROM FEDERAL LAW**

Montana has also enacted legislation to decouple from federal law.

Unemployment benefits: Under the federal Revenue Act of 1978, unemployment benefits were made partially taxable. The Tax Reform Act of 1986 made these benefits fully taxable. In 1979, Montana excluded unemployment benefits from the definition of "gross income" (Chapter 476, Laws of 1979). Montana is one of a handful of states that does not tax these benefits.

Tip income: In 1982, the Tax Equity and Fiscal Responsibility Act added 26 U.S.C. 6053(c), which required employers whose employees failed to report at least 8% of gross sales as tips to

allocate tips equal to 8% of revenue among employees.[3] In 1983, the Legislature passed House Bill No. 841 (Chapter 634, Laws of 1983) to exempt certain tip income from taxation and withholding. The legislation would terminate if Congress passes and the President approves legislation that removes the provision related to the allocation of tip income to employees.

**STATE INDIVIDUAL INCOME TAX FILING**

States that impose income taxes have different filing requirements based on the filing status of the taxpayer (single, head of household, or married). Some states that require married taxpayers to file using the same filing status of the federal return double the bracket widths for joint filers (Alabama, Arizona, Connecticut, Hawaii, Idaho, Kansas, Louisiana, Maine, Nebraska, New York, Oregon), or increase, but don't double, all or some of the bracket widths (Georgia, Minnesota, New Mexico, North Carolina, North Dakota, Oklahoma, Rhode Island, Vermont, Wisconsin). California doubles all bracket widths except the $1,000,000 bracket.

Some other states do not adjust bracket widths for joint filers (Arkansas, Delaware, Iowa, Kentucky, Mississippi, Missouri, Montana, Ohio, South Carolina, Virginia, West Virginia, District of Columbia), but may allow married taxpayers to file separately to avoid the marriage penalty or allow joint filers to make an adjustment to reduce the tax after it is calculated.[4]

States with a single income tax rate (Colorado, Illinois, Indiana, Michigan, Utah[5]) do not need to make adjustments for the marriage penalty.

**MONTANA PROVISIONS RELATED TO FILING SEPARATELY**

Montana allows married taxpayers to file separate returns on the same form. Allowing married taxpayers to file separately and conforming to federal law has resulted in tax consequences for married taxpayers who file a joint federal return and file separate Montana returns.

<u>Social Security benefits:</u> Before 1984, Social Security benefits were exempt from federal and state taxation. In 1983, Congress amended the Social Security Act to tax a portion of Social Security benefits. (A portion of Tier 1 Railroad Retirement benefits were also subject to tax.) The tax on Social Security benefits kicks in if federal adjusted gross income plus nontaxable income and a portion of Social Security benefits exceed certain income threshold amounts.

Senate Bill No. 72 (Chapter 682, Laws of 1985) provided that married taxpayers filing a joint federal return may split equally the federal base used in calculating the federal taxable Social

---

[3] John Robertson, Tina Quinn, and Rebecca C. Carr, "Unreported Tip Income: A Taxing Issue", *The CPA Journal Online*, New York Society of CPAs, December 2006.

[4] Tax Foundation, "State Individual Income Tax Rates, 2009" (as of May 15, 2009), footnote(s). Retrieved from http://www.taxfoundation.org/files/state_individualincome_rates-20090519.pdf, June 8, 2009.

[5] For tax years beginning before January 1, 2008, Utah imposed a graduated income tax.

Security benefits or Tier 1 Railroad Retirement benefits when they file separate Montana income tax returns.

Capital loss deduction and other adjustments: Under federal law, taxpayers are allowed to deduct up to $3,000 of capital losses (net of any capital gains) against ordinary income (26 U.S.C. 1211). Capital gains and losses of married taxpayers filing a joint federal return are computed as if they were the gains and losses of one person. Under prior Montana law, the capital loss of each married taxpayer was limited to $1,500. If one taxpayer had a loss in excess $1,500, the amount of the difference would be an addition to the taxpayer's federal adjusted gross income. The amount of the disallowed loss could be carried forward in subsequent tax years.

Senate Bill No. 281 (Chapter 509, Laws of 2007) provided that married taxpayers filing separate returns may claim the same amount of the capital loss deduction that is allowed on the federal return. The loss must be split equally on each return unless the loss is clearly attributable to one of the spouses.

The legislation also made similar adjustments for passive and rental income losses (26 U.S.C. 469), the deduction for traditional individual retirement contributions (26 U.S.C. 219), the deduction for interest paid for a qualified education loan (26 U.S.C. 221), and the deduction for qualified tuition and related expenses (26 U.S.C. 222).

Partial pension and annuity exemption: On March 28, 1989, the U.S. Supreme Court held invalid in Davis v. Michigan Department of Treasury, 489 U.S. 803, 103 L. Ed. 2d 891, 109 S. Ct. 1500 (1989), a Michigan income tax law that provided a full exemption from state taxation of state and local government pensions but provided only a partial exemption from state taxation of federal pensions. Twenty-four states, including Montana (which provided a full exemption of state and local pensions), were directly affected by Davis. Montana reduced the amount of the exemption for state and local retirees to the first $3,600, the level previously allowed for federal retirees, public pensions of other states, and private pensions (Chapter 823, Laws of 1991).

The pension and annuity income exemption is phased out. The exemption for each taxpayer filing singly, head of household, or married filing separately is reduced by $2 for every $1 of federal adjusted gross income in excess of $30,000. The exemption for married taxpayers filing jointly, whether one spouse or both spouses receives a pension, is reduced by $2 for every $1 of federal adjusted gross income in excess of $30,000 as shown on the joint return. As such, married taxpayers filing jointly may have a lower exemption amount than if they file separately.

**ITEMIZED DEDUCTIONS AND STANDARD DEDUCTION**

Montana law also conforms with federal income tax law in determining itemized deductions (15-30-2131, MCA, formerly 15-30-121, MCA). Montana law provides for some variations in federal law. For example, a taxpayer may not deduct state income taxes paid, but may deduct up to $5,000 in federal income taxes paid, or up to $10,000, if married filing jointly.

A taxpayer may also deduct certain expenses associated with household and dependent care services necessary for gainful employment. The amount of the deduction is phased out for adjusted gross income in excess of $18,000.

Taxpayers may also deduct health insurance premiums and long-term care insurance paid for the benefit of the taxpayer and dependents, parents, and grandparents of the taxpayer. The deduction is not subject to the 7.5% floor for Medicare costs under 26 U.S.C. 213.

Taxpayers may also deduct light vehicle registration fees and per capita livestock fees. Because these fees are not based on the value of the vehicle or livestock, they may not be deducted on the federal return.

In lieu of the itemized deductions, taxpayers may take a standard deduction of 20% of adjusted gross income. Married taxpayers filing separately on the same form must either itemize deductions or take the standard deduction.

**CONCLUDING COMMENTS**

Conforming to federal income tax law generally makes the state's individual income law easier to comply with and to administer. As noted above, federal provisions may have tax consequences for married taxpayers filing separately. The Legislature may enact corrective measures, but those measures are usually delayed.

In addition, conforming the state's income tax base to some other measure of the federal tax base, such as federal taxable income or a percentage of federal tax liability, may make it more difficult to make adjustments to the tax base in those instances in which the Legislature does not like changes in federal tax law. Although state tax law will always involve some modification to federal law, the choice of the federal tax base may cede more or less control to the federal government in the formulation of state tax policy.

Cl0425 9247jfqa.