



## Revenue and Transportation Interim Committee

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### 62nd Montana Legislature

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TO: Committee Members

FROM: Jaret Coles, Staff Attorney

RE: Review of State Income Tax Starting Points and Select Income Tax Returns

DATE: February 6, 2012

Most states use the federal income tax system as a starting point for calculating the amount of taxes payable to the state treasury. (*See Exhibit A.*) This allows taxpayers to copy a single line from IRS Form 1040 that contains a great deal of information, while at the same time giving states assurances of accuracy. It also makes enforcement easier since IRS audits can trigger state audits and adjustments. States typically use one of two aspects of IRS Form 1040 as a starting point, including federal adjusted gross income (AGI) and federal taxable income. A few select states have their own system that is decoupled from the federal system.

#### Adjusted Gross Income as the Starting Point

Montana follows the majority of state taxing jurisdictions by using federal AGI as the first starting point to calculate state income tax liability. According to the Federation of Tax Administrators, the District of Columbia and 28 states use this approach. (*See Exhibit A.*) Since federal AGI does not include exemptions and standard deductions (or itemized deductions for taxpayers that use Schedule A), these states have flexibility to enact their own exemptions and deductions, or they can follow federal law.

#### Taxable Income as the Starting Point

According to the Federation of Tax Administrators, seven states use federal taxable income as the first starting point to calculate state income tax liability. (*See Exhibit A.*) This approach gives states the ability to rely on the same exemptions and deductions that were claimed at the federal level. Additionally, state taxpayers automatically receive the benefit of federal inflationary adjustments (Montana has a statutory adjustment for inflation based on an inflation factor as defined in section 15-30-2101, MCA).

#### Federal Income Taxes Paid as the Starting Point

Until 2001, three states (North Dakota, Rhode Island, and Vermont) multiplied federal taxes paid by a percentage in order to calculate state income tax liability. States that used this system had a tax system that mirrored the progressive nature of the federal tax system. However, during the 2001 federal tax cuts the states using this approach faced declining revenue and they switched methods.<sup>1</sup>

### Select Income Tax Returns

#### *Colorado -- Federal Taxable Income -- Exhibit B*

In December 2011, the Revenue and Transportation Interim Committee received testimony from a tax professional indicating that the Colorado income tax system is simpler than Montana's system. As such, the Colorado form is attached as Exhibit B. The following observations were noted:

- Colorado's instruction booklet is comprised of 24 pages, but Colorado also utilizes supplemental "FYI Publications".
- Colorado uses federal taxable income as a starting point. **(line 1)**
- Colorado adds additional income for taxpayers that itemize by referring to a schedule. Additionally, Colorado adds additional income for bond interest from other states, dependent child income, a conservation credit, unauthorized alien labor services, and certain partnership adjustments. **(lines 2 and 3)**
- Colorado subtracts income from state income tax refunds, U.S. government obligations, a portion of pension or annuity income, capital gains from Colorado sources subject to a \$100,000 limit, contributions to Colorado tuition savings plans, donations to charity for taxpayers who do not itemize, certain public employee retirement benefits, federal railroad retirement benefits, income for Native Americans while working on a reservation, medical savings account interest, and amounts incurred for wildfire mitigation subject to a \$2,500 limit. **(lines 5 through 13)**
- Tax credits are summarized on the primary return by referring to a 3- page form. **(lines 19 and 23)**
- Form 104CR lists multiple state tax credits. **(attached as part of Exhibit B)**

#### *Rhode Island (tax year 2000) -- Federal Taxes Paid -- Exhibit C*

Prior to the 2001 federal tax cuts, Rhode Island's tax return was simple. Average taxpayers who did not claim modifications based on income from other states or obligations of the U.S. government were allowed to calculate state income tax due on two lines using the following method:

Total Federal Tax and Alternative Minimum Tax (IRS Form 1040, line 42)

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<sup>1</sup> Institute on Taxation and Economic Policy, Income Tax Simplification: How to Achieve It (Aug. 2011).

**minus**

Foreign Tax Credits (IRS Form 1040, line 43)  
Child and Dependent Care Expenses (IRS Form 1040, line 44)  
Credit for Elderly or the Disabled (IRS Form 1040, line 45)  
Other Miscellaneous Credits (IRS Form 1040, line 49)  
Earned Income Tax Credit (IRS Form 1040, line 60a)

**equals**

Federal Tax Amount Utilized for Calculating State Tax

**multiplied by**

26%

**equals**

Rhode Island State Income Tax

The instructions for the Rhode Island return were comprised of 2 pages. Rhode Island currently uses federal AGI as the starting point, and complexity has increased.

*Pennsylvania*

Pennsylvania does not rely on IRS Form 1040 for a starting point. However, income tax is still levied against the taxable income of residents and nonresidents.<sup>2</sup> The tax rate is a flat rate of 3.07 percent on all classes of income.<sup>3</sup> Additionally, since gross compensation is taxable, deductions against gross income are limited. There are no provisions for deducting:

- IRA contributions;
- Student loan interest;
- Moving expenses;
- One-half of self employment tax;
- Self-employed health insurance;
- Qualified retirement plans;
- Alimony;
- Standard deductions;
- Itemized deductions;
- Foreign tax credits;
- Dependent care and elderly or disabled credits;
- Child tax credits; or
- Adoption credits.<sup>4</sup>

Expenses that are allowed generally include ordinary and necessary business expenses, but the

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<sup>2</sup> Pennsylvania Department of Revenue, Personal Income Tax Guide, Chapter 6: Brief Overview of Pennsylvania Personal Income Tax, p. 1 (Oct. 21, 2009).

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

<sup>4</sup> *Id.* at pp. 7-8.

allowable expenses are not the same as they are for federal tax purposes.<sup>5</sup> The Pennsylvania Department of Revenue maintains a large number of written publications explaining how to calculate Pennsylvania income tax, and complexities arise given the differences between the federal and state systems.

*Federal Income Tax Return of 1864 - Exhibit D*

During the Civil War, the United States imposed an income tax, although it expired in 1873. A copy of the 1864 federal return is attached to show how things have developed since the beginning.

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<sup>5</sup> *Id.* at pp. 9-10.