



Revenue and Transportation Interim Committee

63rd Montana Legislature

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TO: Committee Members

FROM: Jaret Coles, Staff Attorney

RE: Income Tax Starting Points, Montana's Current System, and Senate Bill No. 282

DATE: August 20, 2014

During the July 2014 Revenue and Transportation Interim Committee meeting, the committee asked for a presentation regarding how [Senate Bill No. 282 \(2013\)](#) was structured. This memorandum provides a summary of the current Montana individual income tax structure in order to show how it differs from [Senate Bill No. 282](#). It then describes some of the changes that were proposed in the enrolled version of [Senate Bill No. 282](#) during the 2013 Legislative Session.

- ★ **NOTE:** This memorandum provides a cursory overview of the manner in which income taxes are determined at the federal and state level. However, a more detailed understanding of how income taxes are calculated may be beneficial. Detailed information regarding income tax calculations is contained in a 38-page staff report to this committee entitled [Individual Income Tax in the United States and Montana: A Roadmap for Future Committee Decisions on House Joint Resolution 13 \(2011\)](#).

Starting Points

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 (FTI).

- ★ **Montana uses federal AGI as a starting point.**
- ★ **Senate Bill No. 282 used FTI as a starting point.**

For tax year 2013 the Internal Revenue Code¹ (I.R.C.) was referenced more than 30 times in Montana's Individual Income Tax Code (Title 15, chapter 30, MCA). When a reference appears to a specific provision of the Internal Revenue Code it encompasses "those provisions as they may be otherwise labeled or further amended." § 15-30-2101, MCA. Additionally, in the event a term is not defined in Montana law "the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code". § 15-30-2620(2), MCA.

Montana's Current Approach

Montana enacted a graduated income tax in 1933 during the Great Depression, and it is currently the largest source of state tax revenue. 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. By using federal AGI as the starting point, whenever Congress adds another exclusion or above-the-line deduction, the same feature can automatically appear (i.e., rolling conformity) in the state returns without any action from the Legislature.

Step 1: Montana Gross Income Calculation

The Montana income tax starts by adopting the federal concept of gross income. Pursuant to § 15-30-2101, MCA, gross income means "the taxpayer's gross income for federal income tax purposes as defined in section 61 of the Internal Revenue Code (26 U.S.C. 61) or as that section may be labeled or amended, excluding unemployment compensation included in federal gross income under the provisions of section 85 of the Internal Revenue Code (26 U.S.C. 85) as amended." The federal definition of gross income is comprehensive. Likewise, the Montana definition of gross income is comprehensive.

Step 2: Montana Adjusted Gross Income and Exemptions

Using federal AGI as the starting point for the calculation of state income tax liability leads to an important question: What is federal AGI? Section 62(a) of the I.R.C. defines AGI as gross income minus certain specific deductions, most of which contain restrictions that are detailed in other code sections. The deductions listed in section 62 are often referred to as "above-the-line" deductions. One of the easiest ways to understand federal AGI is to look lines 23 - 35 of IRS Form 1040.

¹The Internal Revenue Code is codified in Title 26 of the United States Code.

	22	Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶	22	
Adjusted Gross Income	23	Educator expenses	23	
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
	25	Health savings account deduction. Attach Form 8889	25	
	26	Moving expenses. Attach Form 3903	26	
	27	Deductible part of self-employment tax. Attach Schedule SE	27	
	28	Self-employed SEP, SIMPLE, and qualified plans	28	
	29	Self-employed health insurance deduction	29	
	30	Penalty on early withdrawal of savings	30	
	31a	Alimony paid b Recipient's SSN ▶ <input type="text"/>	31a	
	32	IRA deduction	32	
	33	Student loan interest deduction	33	
	34	Tuition and fees. Attach Form 8917	34	
	35	Domestic production activities deduction. Attach Form 8903	35	
		36	Add lines 23 through 35	36
	37	Subtract line 36 from line 22. This is your adjusted gross income ▶	37	

The Montana definition of adjusted gross income has evolved substantially since 1933. Pursuant to § [15-30-2110](#), MCA, *except as otherwise provided* "adjusted gross income is the taxpayer's federal adjusted gross income as defined in section 62 of the Internal Revenue Code, 26 U.S.C. 62". However, there are multiple items that are specifically included in Montana AGI regardless of what Congress does. The Montana additions appear on lines 1 through 16 of Montana Individual Income Tax Form 2, Schedule I.

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Schedule I – Montana Additions to Federal Adjusted Gross Income		Column A (for single, joint, separate, or head of household)		Column B (for spouse when filing separately using filing status 3a)	
Enter your additions to federal adjusted gross income on the corresponding line. File Schedule I with your Montana Form 2.					
1	Interest and mutual fund dividends from state, county or municipal bonds from other states.....	1	00	00	00
2	Dividends not included in federal adjusted gross income.....	2	00	00	00
3	Taxable federal refunds. Complete Worksheet II on page 44.....	3	00	00	00
4	Other recoveries of amounts deducted in earlier years that reduced Montana taxable income. Complete Worksheet IX (available at <i>revenue.mt.gov</i>).....	4	00	00	00
5	Addition to federal taxable social security benefits. Complete Worksheet VIII on page 48.....	5	00	00	00
6	Sole proprietor's allocation of compensation to spouse.....	6	00	00	00
7	Medical care savings account nonqualified withdrawals.....	7	00	00	00
8	First-time home buyer savings account nonqualified withdrawals.....	8	00	00	00
9	Farm and ranch risk management account taxable distributions.....	9	00	00	00
10	Addition for dependent care assistance credit adjustment.....	10	00	00	00
11	Addition for smaller federal estate and trust taxable distributions.....	11	00	00	00
12	Federal net operating loss carryover reported on Form 2, line 21.....	12	00	00	00
13	Share of federal income taxes paid by your S corporation.....	13	00	00	00
14	Title plant depreciation and amortization.....	14	00	00	00
15	Premiums for Insure Montana small business health insurance credit.....	15	00	00	00
16	Other additions. Specify: <input type="text"/>	16	00	00	00
17	Add lines 1 through 16. Enter the total here and on Form 2, line 39. This is your total Montana additions to federal adjusted gross income.....	17	00	00	00

According to the DOR's [Biennial Report](#), some Montana additions to federal AGI were used regularly, while other additions were used sparingly. The [Biennial Report](#) (page 60) contains the following statistics based on full-year residents' returns:

Montana Individual Income Tax				
Income Reported on Full Year Residents Returns				
2010 and 2011				
	2010		2011	
	Count	Total	Count	Total
Montana Additions to Federal Adjusted Gross Income				
Interest on other states' municipal bonds	18,034	114,983,672	18,327	102,910,306
Dividends not included in FAGI	429	1,336,567	343	1,016,687
Taxable federal refunds	87,977	126,871,802	81,228	111,495,115
Recoveries of amounts deducted in earlier years	580	1,297,408	207	449,680
Additions to federal taxable social security or railroad retirement	7,724	12,238,467	7,677	11,813,870
Allocation of compensation to spouse	500	7,780,635	511	8,361,792
Medical savings account nonqualified withdrawals	82	101,799	98	121,307
First-time homebuyer's account nonqualified withdrawals	<10	13,722	<10	12,589
Farm and ranch risk management account taxable distributions	<10	191	<10	10,576
Dependent care assistance credit adjustment	64	106,629	39	49,938
Smaller federal estate and trust taxable distributions	85	66,413	83	786,659
Federal net operating loss carryover	4,689	323,147,050	4,617	405,545,941
Federal taxes paid by your S. corporation	67	192,807	44	48,077
Title plant depreciation	11	18,290	<10	793
Group health premiums reimbursed by Insure Montana credit	1,051	6,032,688	813	4,207,414
Other additions	5,228	142,065,523	4,839	155,292,435
Total Montana Additions	114,737	738,051,483	108,232	802,123,179

There are also multiple items that are specifically subtracted in Montana AGI regardless of what Congress does. The Montana subtractions appear on lines 1 through 34 of Montana Individual Income Tax Form 2, Schedule II.

Form 2, Page 5 – 2013 Social Security Number:

RSB FORM

Schedule II – Montana Subtractions from Federal Adjusted Gross Income

Enter your subtractions from federal adjusted gross income on the corresponding line.
File Schedule II with your Montana Form 2.

Column A (for single, joint, separate, or head of household)
Column B (for spouse when filing separately using filing status 3a)

		Column A (for single, joint, separate, or head of household)	Column B (for spouse when filing separately using filing status 3a)
1	Exempt interest and mutual fund dividends from federal bonds, notes and obligations	00	00
2	Exempt tribal income. Include Form ETM	00	00
3	Exempt unemployment compensation	00	00
4	Exempt workers' compensation benefits	00	00
5	Exempt capital gains and dividends from small business investment companies	00	00
6	State income tax refunds included on Form 2, line 10	00	00
7	Recoveries of amounts deducted in earlier years that did not reduce Montana income tax	00	00
8	Exempt military salary of residents on active duty	00	00
9	Exempt income of nonresident military servicepersons	00	00
10	Exempt life insurance premiums reimbursement for National Guard and Reservist	00	00
11	Partial pension and annuity income exemption. Report Tier II Railroad Retirement on line 23 below. Complete Worksheet IV on page 45	00	00
12	Partial interest exemption for taxpayers 65 and older	00	00
13	Partial retirement disability income exemption for taxpayers under age 65. Include Form DS-1	00	00
14	Exemption for certain taxed tips and gratuities	00	00
15	Exemption for certain income of child taxed to parent	00	00
16	Exemption for certain health insurance premiums taxed to employee	00	00

CONTINUED ON NEXT PAGE

17	Exemption for student loan repayments taxed to health care professional.....	17		00		00
18	Exempt medical care savings account deposits and earnings. Include Form MSA.....	18		00		00
19	Exempt first-time home buyer savings account deposits and earnings. Include Form FTB.....	19		00		00
20	Exempt family education savings account deposits.....	20		00		00
21	Exempt farm and ranch risk management account deposits. Include Form FRM.....	21		00		00
22	Subtraction from federal taxable social security benefits/Tier I Railroad Retirement reported on Form 2, line 20b. Complete Worksheet VIII on page 48.....	22		00		00
23	Subtraction for federal taxable Tier II Railroad Retirement benefits reported on Form 2, line 16b.....	23		00		00
24	Passive loss adjustment.....	24		00		00
25	Capital loss adjustment.....	25		00		00
26	Subtraction of sole proprietor for allocation of compensation to spouse.....	26		00		00
27	Montana net operating loss carryover from Montana Form NOL, Schedule B.....	27		00		00
28	40% capital gain exclusion for pre-1987 installment sales. Complete Worksheet III on page 45.....	28		00		00
29	Subtraction for business-related expenses for purchasing recycled material. Include Form RCYL.....	29		00		00
30	Subtraction for sales of land to beginning farmers.....	30		00		00
31	Subtraction for larger federal estate and trust taxable distribution.....	31		00		00
32	Subtraction for wage deduction reduced by federal targeted jobs credit.....	32		00		00
33	Subtraction for certain gains recognized by liquidating corporation.....	33		00		00
34	Other subtractions. Specify: <input type="text"/>	34		00		00
35	Add lines 1 through 34. Enter the total here and on Form 2, line 40. This is your total Montana subtractions from federal adjusted gross income.	35		00		00

According to the DOR's [Biennial Report](#), some Montana subtractions from federal AGI were used regularly, while other subtractions were used sparingly. The [Biennial Report](#) (page 60) contains the following statistics based on full-year residents' returns:

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Montana Individual Income Tax Income Reported on Full Year Residents Returns 2010 and 2011				
	2010		2011	
	Count	Total	Count	Total
Montana Subtractions from Federal Adjusted Gross Income				
Federal bonds exempt interest	22,473	31,017,274	20,514	25,784,777
Exempt tribal income	7,252	200,800,212	7,175	290,700,359
Exempt unemployment compensation	48,182	268,585,887	42,763	192,862,355
Exempt worker's comp benefits	327	1,990,149	150	786,281
Capital gains from small business investment companies	55	148,811	40	95,032
State tax refunds included in federal AGI	102,810	103,291,864	108,024	97,808,499
Recoveries of amounts deducted in earlier years	145	223,591	23	145,508
Exempt active duty military salary	4,760	153,852,927	4,410	146,526,725
Nonresident exempt military income	117	4,739,141	120	4,212,367
Exempt life insurance premiums reimbursement (National Guard)	56	69,491	46	14,795
Exempt pension income	43,797	142,385,778	44,929	150,893,545
Elderly interest exclusion	70,510	40,226,852	70,622	36,799,111
Exempt retirement disability income (under age 65)	161	786,572	83	364,328
Exempt tip income	13,732	43,592,519	13,863	46,361,919
Exempt income of child taxed to parent	61	113,876	110	252,806
Exempt health insurance premiums taxed to employee	181	677,282	211	843,168
Student loan repayments taxed to health care professional	173	478,765	257	668,300
Medical care savings account exempt deposits	7,812	18,732,448	7,997	19,395,678
First-time homebuyer exempt savings account deposits	140	358,024	155	395,135
Family education savings account exempt deposits	2,780	8,547,258	2,798	6,528,702
Farm and ranch risk management accounts exempt deposits	<10	0	0	0
Subtraction to federal taxable social security/Tier I railroad retirement	33,973	125,589,526	35,183	133,165,545
Subtraction for federal taxable Tier II railroad retirement	3,008	37,812,494	3,007	38,838,218
Subtraction for spouse filing joint return: passive loss carryover	69	143,794	43	88,064
Subtraction for spouse filing joint return: capital loss adjustment	2,763	4,409,741	1,647	3,153,880
Allocation of compensation to spouse	504	7,903,312	530	8,523,880
Montana net operation loss carryover	4,362	308,241,832	4,255	390,379,293
40% capital gain exclusion on pre-1987 installment sales	319	1,155,423	49	123,493
Business expense of recycled material	124	204,911	108	268,011
Sales of land to beginning farmers	<10	5,956	<10	55,961
Larger federal estate and trust taxable distributions	95	180,360	151	383,118
Wage deduction reduced by federal targeted jobs credit	146	1,190,418	72	458,855
Certain gains recognized by liquidating corporation	117	794,177	<10	7,069
Other subtractions	<u>4,620</u>	<u>164,001,056</u>	<u>4,773</u>	<u>165,865,197</u>
Total Montana Subtractions	255,249	1,870,219,349	255,523	1,784,862,577

Section 15-30-2110, MCA, is a lengthy provision that has been amended 52 times since 1933. It is also a provision that can have a big impact on tax policy, what taxpayers pay, and general fund revenue.

Step 3: Montana Itemized vs. Montana Standard Deduction

Similar to the federal income tax, Montana allows taxpayers to choose between itemized deductions or a standard deduction. Generally Montana income tax will be less if a taxpayer takes the larger of the itemized deductions or the standard deduction. The determination of what is allowed for purposes of claiming itemized deductions starts out with a reference to the federal tax code. Pursuant to § 15-30-2131, MCA, the items referred to in I.R.C. sections 161 and 211 are deductible, with some exceptions. Additionally, Montana taxpayers are allowed to take some deductions regardless of what Congress does. The following deductions are not allowed as itemized deductions (computing net income), regardless of what Congress does:

- (1) Personal, living, or family expenses (§§ 15-30-2131(1)(a)(i), 15-30-2133(1), MCA);
- (2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate (§§ 15-30-2131(1)(a)(i), 15-30-2133(2), MCA);
- (3) Any amount expended in restoring property or in making good the exhaustion of the property for which an allowance is or has been made (§§ 15-30-2131(1)(a)(i), 15-30-2133(3), MCA);
- (4) Premiums paid on any life insurance policy covering the life of any officer or employee or of any person financially interested in any trade or business carried on by the taxpayer when the taxpayer is directly or indirectly a beneficiary under the policy (§§ 15-30-2131(1)(a)(i), 15-30-2133(4), MCA);
- (5) Expenses that are generally associated with the production of exempt or excludable income (§§ 15-30-2131(1)(a)(i), 15-30-2133(5), MCA);
- (6) State income taxes paid (§ 15-30-2131(1)(a)(ii), MCA); and
- (7) A charitable contribution using a charitable gift annuity unless the annuity is a qualified charitable gift annuity under Montana law (§§ 15-30-2131(1)(a)(v), 33-20-701, MCA).

The following deductions are allowed as itemized deductions (computing net income), regardless of what Congress does:

- (1) Federal income tax paid within the tax year, not to exceed \$5,000 for each taxpayer filing singly, head of household, or married filing separately or \$10,000 if married and filing jointly (§ 15-30-2131(1)(b), MCA);
- (2) Subject to a variety of limitations, expenses of household and dependent care services (§ 15-30-2131(1)(c), MCA);
- (3) Political contributions determined in accordance with the provisions of section 218(a) and (b) of the Internal Revenue Code of 1954 (now repealed) that were in effect for the tax year that ended December 31, 1978 (§ 15-30-2131(1)(d), MCA);
- (4) That portion of expenses for organic fertilizer and inorganic fertilizer produced as a byproduct and not otherwise deducted in computing taxable income (§ 15-30-2131(1)(e), MCA);
- (5) Subject to conditions, contributions to the child abuse and neglect prevention program (§ 15-30-2131(1)(f), MCA);
- (6) The entire amount of premium payments made by the taxpayer, except premiums deducted in determining Montana adjusted gross income, or for which a credit was claimed for qualified elderly care expenses (§ 15-30-2131(1)(g), MCA);
- (7) Montana light vehicle registration fees (§ 15-30-2131(1)(h), MCA);
- (8) Montana per capita livestock fees (§ 15-30-2131(1)(i), MCA);
- (9) Donations to the veterans' services account and the state veterans' cemetery program and the patriotic license plate surcharge (§ 15-30-2142, MCA).

According to the DOR's [Biennial Report](#), some Montana itemized deductions were used regularly, while other itemized deductions were used sparingly. The [Biennial Report](#) (page 61) contains the following statistics based on full-year residents' returns:

Montana Individual Income Tax				
Deductions Reported on Full Year Residents Returns				
2010 and 2011				
	2010		2011	
	Count	Total	Count	Total
Deductions				
Total medical expenses*	133,552	545,701,986	133,861	545,817,871
Deductible medical expenses	71,855	304,436,666	70,306	301,438,269
Medical insurance premiums not deducted elsewhere	102,983	353,880,862	103,615	364,569,523
Long-term care insurance premiums	13,471	27,300,594	13,475	33,985,594
Federal Income Tax				
Federal income tax withheld*	250,870	9,270,288,809	264,724	9,664,747,196
Federal income tax estimated payments*	47,104	530,290,626	47,233	582,210,945
Last year's federal income tax paid (e.g. with return)*	48,875	231,044,373	54,015	278,790,903
Federal income tax from previous years*	4,742	19,035,803	4,763	22,812,278
Total federal income tax deduction	279,100	1,015,380,042	291,483	1,132,026,533
State or Local Sales Tax*	n/a	n/a	433	446,177
Local income taxes	302	112,039	305	198,088
Real estate taxes	210,973	400,710,387	211,586	411,428,092
Personal property taxes	162,911	52,671,671	167,216	52,698,081
Other deductible taxes	27,639	10,298,211	25,435	9,209,030
Home mortgage interest	159,911	1,075,407,210	159,013	1,008,850,204
Unreported home mortgage interest	6,404	17,246,577	6,341	16,732,698
Unreported points	23,243	6,774,876	22,487	6,128,734
Qualified mortgage ins premiums	19,897	23,239,755	20,847	20,843,664
Investment interest	8,402	37,072,979	8,840	33,364,845
Contributions by cash or check	169,405	443,302,712	169,378	454,876,219
Contributions other than cash or check	71,377	59,815,976	72,985	64,804,361
Carryover of contributions from previous years	3,841	34,781,509	3,662	38,451,707
Child and dependent care expenses	833	1,468,425	851	1,807,288
Casualty and theft losses	499	4,821,842	659	9,738,044
Business Expenses				
Unreimbursed employee business expenses*	56,556	169,613,690	57,209	186,407,740
Other business expenses*	143,319	116,861,859	147,012	126,923,598
Total business expenses*	162,360	286,475,549	166,296	312,331,338
Net deductible unreimbursed business expenses	57,089	198,644,087	58,739	219,574,473
Political contributions	9,052	622,083	7,867	729,898
All other miscellaneous deductions not subject to 2% floor	2,126	7,634,906	2,701	5,825,034
Gambling losses	<u>1,191</u>	<u>10,772,583</u>	<u>1,246</u>	<u>12,302,315</u>
Total itemized deductions	310,090	4,086,694,888	318,088	4,197,828,869
Standard deductions	<u>200,210</u>	<u>708,794,565</u>	<u>197,549</u>	<u>4,911,588,629</u>
Total deductions	525,972	4,795,489,251	530,331	4,911,588,629

* Indented items either are part of another line or include another line. They are not part of the total.

Step 4: Montana Personal Exemptions

Similar to the federal income tax, Montana allows taxpayers to claim personal exemptions. Pursuant to § 15-30-2114, MCA, the personal exemption is adjusted for inflation and is

calculated by multiplying the dollar amount of the exemption by the number of exemptions (i.e., taxpayer, spouse, children, dependents, additional exemption for age 65 and above, additional exemption for blind). Taking the inflation factor into account, the personal exemption in tax year 2013 was \$2,280.

Step 5: Calculate Montana Taxable Income

Pursuant to § 15-30-2101, MCA, Montana taxable income means "the adjusted gross income of a taxpayer less the deductions and exemptions provided for" under the Montana tax code. As such, taxable income is calculated using Montana AGI, the higher of itemized deductions or the standard deduction, and allowable personal exemptions.

Step 6: Montana Tax Calculation.

Montana uses a single rate structure for all taxpayers, regardless of filing status. 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. Montana's rate structure is progressive, since taxpayers with higher incomes pay a higher percentage of their income in tax. However, unlike the federal brackets Montana's rates max out at a fairly low level of taxable income. The easiest way to calculate total Montana tax is to use the tax tables published by the DOR. These tables have already taken into account the progressive rates of tax and the inflation factor. Montana's tax table for tax year 2013 was as follows:

2013 Montana Individual Income Tax Table				
If Your Taxable Income Is More Than	But Not More Than	Multiply Your Taxable Income By	And Subtract	This Is Your Tax
\$0	\$2,800	1% (0.010)	\$0	
\$2,800	\$4,900	2% (0.020)	\$28	
\$4,900	\$7,400	3% (0.030)	\$77	
\$7,400	\$10,100	4% (0.040)	\$151	
\$10,100	\$13,000	5% (0.050)	\$252	
\$13,000	\$16,700	6% (0.060)	\$382	
More Than \$16,700		6.9% (0.069)	\$532	

Step 7: Montana Tax Credits

Similar to federal income taxes, the final computation deals with applying Montana tax credits and payments made through withholdings or estimated payments toward the tax in order to determine the size of the refund or the amount of money due. In some situations a tax credit can reduce tax dollar for dollar. Also, unlike deductions, when Congress adds another federal tax credit it does not generally appear automatically as a credit for Montana individual income tax purposes.

Tax credits can be separated into three categories: nonrefundable credits with no carryover, nonrefundable credits with a carryover, and refundable credits. When a credit is nonrefundable, a taxpayer can only offset tax liability with the credit. In the event tax liability is less than the amount of the credit, a refund will not be issued and the taxpayer cannot reduce tax liability below zero. However, if a nonrefundable credit has a carryover provision, the taxpayer may be able to utilize the remaining portion of the credit in another tax year. Moreover, if a tax credit is refundable the taxpayer may actually receive a refund in situations where tax liability is less than the amount of the credit. Some Montana tax credits are used frequently while other credits are not as popular. The following charts from the [Biennial Report](#) (p. 63 and p. 266 of the [tax expenditure report](#)) shed light on how often credits are used and their corresponding impact on the general fund.

Capital Gains Credit								
	Residents		Non-Residents		Part-Year Residents		Total	
	N	\$	N	\$	N	\$	N	\$
2005	53,187	\$15,440,738	9,799	\$3,942,692	2,418	\$443,246	65,404	\$19,826,676
2006	61,392	\$19,599,422	10,474	\$2,931,577	2,575	\$419,008	74,441	\$22,950,007
2007	68,967	\$40,025,383	10,329	\$3,358,241	2,779	\$752,115	82,075	\$44,135,739
2008	41,242	\$26,151,925	8,031	\$8,609,630	1,442	\$457,981	50,715	\$35,219,536
2009	24,961	\$17,974,296	5,346	\$1,918,020	766	\$175,272	31,073	\$20,067,588
2010	31,812	\$19,642,186	7,340	\$3,794,662	1,043	\$318,107	40,195	\$23,754,954
2011	37,812	\$19,621,982	8,790	\$2,539,063	1,266	\$822,209	47,868	\$22,983,254

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Montana Individual Income Tax
Credits Reported on Full Year Residents Returns
2010 and 2011

	2010		2011	
	Count	Total	Count	Total
Credits				
Non-Refundable and No Carryover Credits				
Other states' income tax credit	11,308	20,608,363	11,471	19,090,209
College contribution tax credit	2,900	253,119	2,840	238,141
Qualified endowment tax credit	612	1,737,766	577	1,755,033
Energy conservation tax credit	28,704	10,233,928	16,645	5,588,577
Alternative fuel tax credit	43	25,281	17	26,822
Rural physician's tax credit	14	51,712	0	0
Insurance for uninsured Montanans credit	349	276,066	262	192,670
Elderly care tax credit	53	75,912	52	77,468
Recycling tax credit	109	492,609	94	538,163
Oil seed crushing/biodiesel facility credit	0	0	<10	8,536
Biodiesel blending/storage tank credit	<10	907	<10	46,755
Non-Refundable but With Carryover Credits				
Contractor's gross receipts tax credit	584	3,887,979	636	4,426,212
Geothermal systems tax credit	290	453,992	241	318,928
Alternative energy systems credit	2,476	1,377,478	1,534	823,533
Alternative energy production tax credit	<10	11,360	<10	7,290
Dependent care assistance credit	<10	14,595	10	26,039
Historic property preservation tax credit	22	495,691	24	105,214
Infrastructure user fee credit	13	45,258	12	24,414
Empowerment zone credit	<10	600	<10	475
Research activities tax credit	17	149,977	<10	149,633
Mineral exploration tax credit	12	26,895	0	0
Film production employment tax credit	0	0	0	0
Adoption credit	324	322,517	289	274,849
Total Non-Refundable Credits	45,199	40,542,005	33,106	33,718,961
Refundable Credits				
Elderly homeowner/renter tax credit*	17,127	8,467,974	16,593	8,167,841
Film production employment tax credit	<10	11,480	<10	5,316
Film qualified expenditure tax credit	<10	17,217	<10	20,067
Insure MT small business health insurance credit	952	2,890,619	833	2,156,183
Emergency lodging credit	0	0	<10	863
Total Refundable Credits	18,080	11,387,290	17,423	10,350,270
Total Credits	81,807	73,350,621	65,928	62,934,220

* Credits claimed on tax returns. See the Property Tax section for credits claimed with no income tax return.

Taxable Income as the Starting Point -- Senate Bill No. 282 Approach

According to the [Federation of Tax Administrators](#), eight states use federal taxable income (FTI) 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 § 15-30-2101, MCA).

This leads to the important question of what is FTI? Section 63 of the I.R.C. defines FTI as gross income minus the deductions allowed by chapter 1 of the I.R.C. (other than the standard deduction). One of the easiest ways to understand FTI is to look lines 38 - 43 of IRS Form 1040.

Form 1040 (2013)		Page 2		
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38		
	39a Check <input type="checkbox"/> You were born before January 2, 1949, <input type="checkbox"/> Blind. Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1949, <input type="checkbox"/> Blind. checked ► 39a			
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ► 39b <input type="checkbox"/>			
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$6,100 Married filing jointly or Qualifying widow(er), \$12,200 Head of household, \$8,950	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40		
	41 Subtract line 40 from line 38	41		
	42 Exemptions. If line 38 is \$150,000 or less, multiply \$3,900 by the number on line 6d. Otherwise, see instructions	42		
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43		
	44 Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/>	44		
	45 Alternative minimum tax (see instructions). Attach Form 6251	45		
	46 Add lines 44 and 45	46		
	47 Foreign tax credit. Attach Form 1116 if required	47		
	48 Credit for child and dependent care expenses. Attach Form 2441	48		
	49 Education credits from Form 8863, line 19	49		
50 Retirement savings contributions credit. Attach Form 8880	50			
51 Child tax credit. Attach Schedule 8812, if required	51			
52 Residential energy credits. Attach Form 5695	52			
53 Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>	53			
54 Add lines 47 through 53. These are your total credits	54			
55 Subtract line 54 from line 46. If line 54 is more than line 46, enter -0-	55			

Form 1040, Line 40 -- To Itemize, or Not to Itemize

In calculating FTI, a taxpayer starts out with federal AGI (line 38), and a taxpayer is given the choice to take the itemized deductions or the standard deduction (line 40). In most cases federal income tax will be less if a taxpayer takes the larger of the itemized deductions or the standard deduction. If a taxpayer does not itemize, then in standard deduction amount is listed in the left hand margin of Form 1040. Itemized deductions are claimed on IRS Form 1040 - Schedule A:

**SCHEDULE A
(Form 1040)**

Department of the Treasury
Internal Revenue Service (IRS)

Itemized Deductions

► Information about Schedule A and its separate instructions is at www.irs.gov/schedulea.
► Attach to Form 1040.

OMB No. 1545-0074

2013
Attachment
Sequence No. **07**

Name(s) shown on Form 1040

Your social security number

Medical and Dental Expenses		Caution. Do not include expenses reimbursed or paid by others.			
1	Medical and dental expenses (see instructions)	1			
2	Enter amount from Form 1040, line 38	2			
3	Multiply line 2 by 10% (.10). But if either you or your spouse was born before January 2, 1949, multiply line 2 by 7.5% (.075) instead	3			
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-				4
Taxes You Paid		5 State and local (check only one box):			
		a <input type="checkbox"/> Income taxes, or		5	
		b <input type="checkbox"/> General sales taxes			
6	Real estate taxes (see instructions)	6			
7	Personal property taxes	7			
8	Other taxes. List type and amount ►	8			
9	Add lines 5 through 8				9
Interest You Paid		10 Home mortgage interest and points reported to you on Form 1098		10	
Note. Your mortgage interest deduction may be limited (see instructions).		11 Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ►		11	
		12 Points not reported to you on Form 1098. See instructions for special rules.		12	
		13 Mortgage insurance premiums (see instructions)		13	
		14 Investment interest. Attach Form 4952 if required. (See instructions.)		14	
		15 Add lines 10 through 14			15
Gifts to Charity		16 Gifts by cash or check. If you made any gift of \$250 or more, see instructions.		16	
If you made a gift and got a benefit for it, see instructions.		17 Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500		17	
		18 Carryover from prior year		18	
		19 Add lines 16 through 18			19
Casualty and Theft Losses		20 Casualty or theft loss(es). Attach Form 4684. (See instructions.)			20
Job Expenses and Certain Miscellaneous Deductions		21 Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ►		21	
		22 Tax preparation fees		22	
		23 Other expenses—investment, safe deposit box, etc. List type and amount ►		23	
		24 Add lines 21 through 23		24	
		25 Enter amount from Form 1040, line 38		25	
		26 Multiply line 25 by 2% (.02)		26	
		27 Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-			27
Other Miscellaneous Deductions		28 Other—from list in instructions. List type and amount ►			28
Total Itemized Deductions		29 Is Form 1040, line 38, over \$150,000?			29
		<input type="checkbox"/> No. Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40.			
		<input type="checkbox"/> Yes. Your deduction may be limited. See the Itemized Deductions Worksheet in the instructions to figure the amount to enter.			
		30 If you elect to itemize deductions even though they are less than your standard deduction, check here			

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 17145C

Schedule A (Form 1040) 2013

Form 1040, Line 42 -- Personal Exemption

In calculating FTI, most taxpayers are allowed to offset income with a personal exemption (line 42). As the name implies, a taxpayer is exempt from paying income tax on a certain amount of income. The personal exemption is adjusted for inflation and is calculated by multiplying the dollar amount of the exemption by the number of exemptions (i.e., taxpayer, spouse, children, dependents). For example, a family of four would be entitled to an exemption of \$15,600 (\$3,900 x 4) in tax year 2013. In the past this exemption has been subject to a phaseout amount whereby a taxpayer with AGI above a "threshold amount" of \$150,000 would face a reduction in the exemption. The personal exemption is essentially a floor that ensures that a taxpayer will not be taxed unless income is greater than the exemption.

Form 1040, Line 43 -- Taxable Income

Taxable income is calculated using AGI, the higher of itemized deductions or the standard deduction, and allowable personal exemptions. For example taxable income for a family of four filing a married filing joint return with \$100,000 AGI and \$20,000 in itemized deductions would be calculated as follows:

AGI:	\$100,000	
Minus: Itemized Deduction	- \$ 20,000	(the standard Deduction was \$12,200 in 2013)
Minus: Personal Exemptions	- \$ 15,600	(\$3,900 x 4 in 2013)
TAXABLE INCOME	= \$ 64,400	

Senate Bill No. 282 -- Highlights

The following are some highlights regarding the [enrolled version of Senate Bill No. 282](#):

- ! Section 1 is a new section that is the heart of the bill (along with the definitions in section 7). Similar to eight other states, [section 1] provides that FTI (Form 1040, line 43) is the starting point, with limited adjustments.
- ! Section 1(2) provides that certain items are added back into the definition of FTI. These items include income that may be exempt under federal law but is still taxable in Montana (*i.e.*, bonds from another state).
- ! Section 1(3) provides that certain items that are included in FTI are subtracted out of the definition for state tax purposes in order to make the items exempt under Montana law. The Senate Taxation Committee added exemptions for pension and annuity income and an additional election for taxpayers age 65 or older.

- ! Section 15-30-2110, MCA, which uses federal AGI (with various additions and subtractions to federal AGI) was repealed.
- ! Section 7 amends various definition in § 15-30-2101, MCA, in order to facilitate the changes. For example, on page 13 there is a new definition for Montana taxable income that cites back to section 1. Additionally, section 9 amends § 15-30-2103, MCA, by imposing a tax on "Montana taxable income".
- ! The filing status definitions in § 15-30-2101, MCA, mirrored federal law, which set the framework for repealing married filing separate on the same form. For example:
 - "Head of household" (§ 15-30-2101(11), MCA);
 - "Joint return" (§ 15-30-2101(15), MCA);
 - "Married individual" (§ 15-30-2101(20), MCA); and
 - "Surviving Spouse" (§ 15-30-2101(34), MCA).
- ! All sections that used AGI were amended or repealed, since the bill used FTI as the starting point.
 - Montana-specific itemized deductions were eliminated by the repeal of § 15-30-2131, MCA, and the Montana standard deduction was eliminated by the repeal of § 15-30-2132, MCA.
- ! Section 9 amends § 15-30-2103, MCA, by striking the seven brackets under existing law and adding two brackets. Additionally, there are different rates, depending on filing status, and a rate reduction of 1.5% for capital gain income (instead of the existing 2% capital gains credit).
- ! Section 11 amends § 15-30-2113, MCA, and requires the same filing status as the federal return. However, there is an escape clause for nonresident filers.
- ! Section 12 amends § 15-30-2151, MCA, and follows federal law for estates and trusts.
- ! Section 27 reduces the corporate income tax rate from 6 ¾% to 6.5% and the water's edge from 7% to 6.75%.
- ! Section 57 is the repealer that generally deletes:
 - Statutes that were needed for Montana adjusted gross income calculations; and
 - Various tax credits and deductions (see the [Fiscal Note](#) for more detail). Some of the tax credits (and deductions) that were repealed in Senate Bill No. 282 include:
 - ◆ Empowerment Zone Credit;
 - ◆ Credit for Energy-conserving Investments;
 - ◆ Alternative Fuel Conversion Credit;
 - ◆ Capital Gain Exclusion from Sale of Mobile Home Park;
 - ◆ New or Expanded Industry Credit;
 - ◆ Deduction for Purchase of Montana-produced Organic or Inorganic Fertilizer;
 - ◆ Geothermal Heating System Credit;
 - ◆ Alternative Energy Production Credit;
 - ◆ Mineral Exploration Credit;
 - ◆ Recycling Credit and Deduction;
 - ◆ Biodiesel Credits; and
 - ◆ Contractor's Gross Receipts Tax Credit.

- ! Section 58 is a transition paragraph that allows carryforwards if they were allowed under existing law before repeal.
- ! Section 59 is a transition paragraph that gives a taxpayer an option to make an election to account for items that are different under federal and state law. This includes passive activity losses, capital losses, IRA conversion, Net Operating Losses, adjusted basis for assets, liabilities with different adjusted basis, and Montana refunds.

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EXHIBIT A

STATE PERSONAL INCOME TAXES: FEDERAL STARTING POINTS
(as of January 1, 2014)

STATE	Relation to Federal Internal Revenue Code	Federal Tax Base Used as Starting Point to Calculate State Taxable Income
ALABAMA	---	---
ALASKA	no state income tax	---
ARIZONA	1/1/12	adjusted gross income
ARKANSAS	---	---
CALIFORNIA	1/1/09	adjusted gross income
COLORADO	Current	taxable income
CONNECTICUT	Current	adjusted gross income
DELAWARE	Current	adjusted gross income
FLORIDA	no state income tax	---
GEORGIA	1/3/13	adjusted gross income
HAWAII	1/2/13	adjusted gross income
IDAHO	1/1/13	taxable income
ILLINOIS	Current	adjusted gross income
INDIANA	1/1/13	adjusted gross income
IOWA	1/1/13	adjusted gross income
KANSAS	Current	adjusted gross income
KENTUCKY	12/31/06	adjusted gross income
LOUISIANA	Current	adjusted gross income
MAINE	1/2/13	adjusted gross income
MARYLAND	Current	adjusted gross income
MASSACHUSETTS	1/1/05	adjusted gross income
MICHIGAN	Current (a)	adjusted gross income
MINNESOTA	1/3/13	taxable income
MISSISSIPPI	---	---
MISSOURI	Current	adjusted gross income
MONTANA	Current	adjusted gross income
NEBRASKA	Current	adjusted gross income
NEVADA	no state income tax	---
NEW HAMPSHIRE	on interest & dividends only	---
NEW JERSEY	---	---
NEW MEXICO	Current	adjusted gross income
NEW YORK	Current	adjusted gross income
NORTH CAROLINA	1/2/13	taxable income
NORTH DAKOTA	Current	taxable income
OHIO	3/22/13	adjusted gross income
OKLAHOMA	Current	adjusted gross income
OREGON	1/3/13	taxable income
PENNSYLVANIA	---	---
RHODE ISLAND	Current	adjusted gross income
SOUTH CAROLINA	1/2/13	taxable income
SOUTH DAKOTA	no state income tax	---
TENNESSEE	on interest & dividends only	---
TEXAS	no state income tax	---
UTAH	Current	adjusted gross income
VERMONT	1/1/12	taxable income
VIRGINIA	1/2/13	adjusted gross income
WASHINGTON	no state income tax	---
WEST VIRGINIA	1/2/13	adjusted gross income
WISCONSIN	12/31/10	adjusted gross income
WYOMING	no state income tax	---
DIST. OF COLUMBIA	Current	adjusted gross income

Source: Compiled by the Federation of Tax Administrators from various sources.

Notes:

--- state does not employ a federal starting point. Current indicates state has adopted IRC as currently in effect. Dates indicate state has adopted IRC as amended to that date.

(a) Michigan's taxpayers can choose to use either current or 1/1/96 federal law.