MONTANA LEGISLATIVE SERVICES DIVISION
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HJ 35 Tax Study Committee
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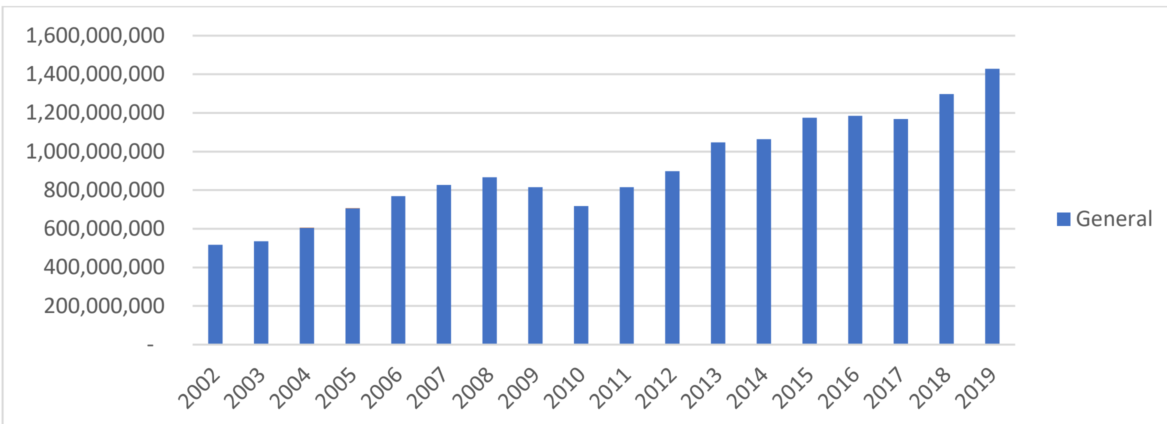
INDIVIDUAL INCOME TAX OVERVIEW

LARGEST GENERAL FUND REVENUE SOURCE

The individual income tax is the largest source of General Fund revenue. The $1.4 billion collected in fiscal year 2019 accounted for 56% of General Fund revenue.[1]



Source: Legislative Fiscal Division

WHO PAYS THE INDIVIDUAL INCOME TAX?

The individual income tax is paid by Montana residents and nonresidents with income taxable in Montana. Some businesses also pay taxes through the individual income tax because the income of the business is attributed to the business owner. The types of business income included on individual income tax returns includes income of sole proprietors, S. corporations, partnerships, and disregarded entities such as a single member LLC.

(MONTANA) INCOME TAXES ARE COMPLICATED

This section provides an overview of how to calculate Montana income taxes. Montana individual income tax laws are codified in Title 15, chapter 30, MCA.

[1] LFD Revenue Team, "FY 2020 General Fund Update #3," February 10, 2010, p. 4.

STEP 1: DETERMINE FILING STATUS

Like many states, Montana uses information from the federal income tax as a starting point to calculate Montana income taxes. Both Montana law and federal law also use a progressive rate structure, which means that the tax rate increases with income.

However, Montana uses only one tax rate schedule and it applies to all taxpayers regardless of their filing status. The practice under federal law and in some other states is to use different tax rate schedules for different filing statuses. For example, federal law provides income brackets for married taxpayers filing jointly (MFJ) that are generally double those for single taxpayers.

Married taxpayers who file jointly in Montana are subject to the same rate schedule as single taxpayers. If both spouses have income, they will likely face a lower tax burden by filing married filing separately (MFS) because each spouse's income is taxed first at the lower tax rates. Many married Montanans face the complexity of filing their federal taxes with a married filing jointly status and their state taxes with a married filing separately status.

Though choosing a filing status is one of the first steps on Montana's Form 2, married taxpayers may need to work through the calculations in the following sections with their income combined and separate to determine which filing status to select.

Married taxpayers who file jointly list all dollar amounts in Column A of Form 2. Married taxpayers who file separately can still use a single Form 2. The spouses follow the steps in the following sections and list one spouse's information in each column. This method of filing, called married filing separately on the same form, is easier for the taxpayer and the Department of Revenue because all income, deductions, exemptions, and credits are included on one form.

STEP 2: FEDERAL ADJUSTED GROSS INCOME

The Montana income tax calculation begins with federal adjusted gross income. The income items reported on the federal return are also reported on the Montana return. This allows the Department of Revenue to gather data on sources of income and adjustments to income, which improves the state's revenue estimating ability.

The items of income used to calculate federal adjusted gross income are reported on the first page of Form 2 and Schedule 1:

- Wages, salaries, and tips;
- Tax-exempt and taxable interest;
- Qualified dividends and ordinary dividends;
- IRA distributions, including the taxable amount;
- Pensions and annuities, including the taxable amount;

- Social security benefits, including the taxable amount;
- Capital gains or losses; and
- Other income from Schedule 1, including taxable state refunds; alimony received; business income or loss; income from real estate, royalties, partnerships, S. corporations, and trusts; farm income or loss; and unemployment compensation.

The income items above are adjusted to arrive at federal adjusted gross income. These adjustments, also included on Schedule 1, are often referred to as above-the-line deductions. A taxpayer does not have to itemize deductions to claim these deductions, which include:

- Educator expenses;
- Certain business expenses;
- Health savings account deduction;
- Moving expenses for members of the Armed Forces;
- Certain self-employment taxes, insurance, and retirement plans;
- Penalty on early withdrawal of savings;
- Alimony paid;
- IRA deduction;
- Student loan interest deduction; and
- Tuition and fees.

STEP 3: MONTANA ADJUSTED GROSS INCOME

Montana law includes about 50 additions to and subtractions from federal adjusted gross income. Additions are items not taxed under federal law that are taxed in Montana. Subtractions are exempt from taxation in Montana but taxed by the federal government. Accounting for these adjustments results in Montana adjusted gross income. A "Montana Additions Schedule" and a "Montana Subtractions Schedule" are on pages 4-5 of Form 2.

Montana Additions on full-year resident returns totaled more than $830 million in 2017. The largest Montana Additions listed on full-year resident taxpayer returns were: federal net operating loss carryover, taxable federal refunds, interest on other states' municipal bonds, additions to federal taxable social security or railroad retirement, and allocation of compensation to spouse.[2]

There are more than twice as many Montana subtractions as there are Montana additions. Montana subtractions accounted for nearly $1.8 billion in 2017. The largest Montana subtractions listed on full-year resident returns were:

[2] Department of Revenue, "Biennial Report July 1, 2016 - June 30, 2018," p. 61.

Montana net operating loss carryover, exempt tribal income, subtraction to federal taxable social security, active duty military salary, and exempt pension income.[3]

STEP 4: STANDARD DEDUCTION OR ITEMIZED DEDUCTIONS

A Montana taxpayer can take a standard deduction or itemize deductions. The standard deduction is 20% of Montana adjusted gross income subject to a minimum and maximum provided for in law and increased annually for inflation. The 2019 figures are shown in the following table. In 2017, 206,961 full-year resident returns claimed the standard deduction, accounting for nearly $859 million. [4]

	Single/Married Filing Separately	Married Filing Jointly/Head of Household
Minimum Standard Deduction	$2,090	$4,180
Maximum Standard Deduction	$4,710	$9,420

Taxpayers who itemize deductions report dollar amounts for eligible deductions on the Itemized Deductions Schedule on page 7 of Form 2. Montana's itemized deductions are the same as federal itemized deductions with a few differences:

- Montana law allows a federal income tax deduction of up to $5,000 (or $10,000 for MFJ). Taxpayers itemizing on the federal return receive the deduction for state income taxes paid.
- Montana allows an itemized deduction for medical insurance premiums and long-term care insurance premiums. Under federal law, these premiums are added to other deductible medical expenses and may only be claimed as an itemized deduction if they exceed 7.5% of adjusted gross income.
- Montana allows the following itemized deductions that federal law does not allow: light vehicle registration fees, per capita livestock fees, child and dependent care expenses, and political contributions up to $100.

In 2017, 345,356 full-year resident returns claimed itemized deductions totaling $4.6 billion.[5]

STEP 5: DEPENDENTS AND EXEMPTIONS

Montana law provides an exemption, or a reduction in income, for the taxpayer, the spouse if filing jointly, and each dependent. A taxpayer or spouse who is 65 or older, a taxpayer or spouse who is blind, and a disabled dependent

[3] Department of Revenue, "Biennial Report July 1, 2016 - June 30, 2018," p. 61.
[4] Department of Revenue, "Biennial Report July 1, 2016 - June 30, 2018," p. 62.
[5] Department of Revenue, "Biennial Report July 1, 2016 - June 30, 2018," p. 62.

each receive an additional exemption. For 2019, each exemption is $2,510. The exemption amount is adjusted annually for inflation.

STEP 6: APPLY TAX RATE TO MONTANA TAXABLE INCOME

A taxpayer calculates Montana taxable income by going through steps 2 through 5: determining federal adjusted gross income, adjusting for Montana additions and subtractions, subtracting the standard deduction or itemized deductions, and subtracting exemptions. The result is Montana taxable income, which is entered on Line 14 of Form 2.

Tax liability before tax credits is calculated using the table on the last page of Form 2. The income brackets in law are adjusted for inflation annually. The following table shows tax rates for 2019.

Taxable Income Amount	Rate of Tax
First $3,100	1%
Next $2,300	2%
Next $2,800	3%
Next $2,900	4%
Next $3,200	5%
Next $4,100	6%
Above $18,400	6.9%

STEP 7: TAX CREDITS

To determine tax liability, the taxpayer subtracts tax credits from the amount determined in step 6, which is known as tax liability before tax credits. Tax credits are either refundable or nonrefundable. Refundable credit amounts are refunded to the taxpayer if they exceed tax liability. Nonrefundable credits are not refunded to the taxpayer if they exceed tax liability.

Montana has four refundable individual income tax credits: the earned income tax credit, the elderly homeowner and renter tax credit, the emergency lodging tax credit, and the unlocking state lands tax credit. Some tax credits that are not refundable may be carried to another tax year if they exceed tax liability in the current tax year. Carryovers of credits claimed in previous years are also calculated in this step.

There are 31 Montana income tax credits that may be claimed in 2019. This includes 8 credits that may be claimed only by individuals, 10 credits that may be claimed only by businesses, and 13 credits that may be claimed by both. Full-year residents claimed $97.6 million in tax credits in 2017.[6]

STEP 8: TAXES OR REFUND DUE

The final step is to calculate whether the taxpayer owes money to the state or whether the taxpayer is due a refund. Many taxpayers have taxes withheld from their income. Taxpayers who do not have taxes withheld may make estimated payments throughout the tax year. The final step is to reconcile income taxes withheld and estimated payments with the actual amount due to determine whether the taxpayer owes additional taxes or is owed a refund. The tax due or refund amount also accounts for any penalties or interest.

FEW BIG CHANGES TO THE INCOME TAX

Montana has had an income tax since 1933 but the Legislature has made few significant changes to the tax.

The Montana electorate approved Initiative No. 86 in 1980 to index for inflation income brackets, exemptions, and the standard deduction. This prevents income tax burdens from increasing automatically due to inflation.

The 2003 Legislature passed a tax bill that included changes to the individual income tax, adopted a sales tax on lodging and rental cars, and increased the tax on cigarettes and tobacco products. The individual income tax changes included:

- reducing the number of income brackets and reducing of the top tax rate;
- enacting the capital gains tax credit;
- limiting the deduction for federal income taxes paid to $5,000; and
- doubling personal exemptions from $800 to $1,900.

The Legislature has also made many changes to Montana additions and Montana subtractions, itemized deductions, and tax credits throughout the years. While the individual changes may seem minor when enacted, the cumulative effect of these revisions contribute to the complexity of the Montana individual income tax.

SHOULD MONTANA'S INDIVIDUAL INCOME TAX BE REVISED?

Montana is very reliant on the individual income tax. The tax can be volatile during a recession and demographics may impact future revenue collections. The Legislature has also shown interest in simplifying the individual income

[6] Department of Revenue, "Biennial Report July 1, 2016 - June 30, 2018," p. 63-64. Total includes total from table on p. 63 and capital gains credits claimed on p. 63.

tax.[7] If the Committee is interested in revising the individual income tax, it would be worthwhile to state the goals of any revisions.

The National Conference of State Legislature's principles for evaluating state tax sources may be useful when considering possible goals. The goals are listed below with basic information about how the goal applies to the individual income tax.

- **Reliability:** The individual income tax raises a significant portion of Montana's general fund revenue and is generally reliable, though susceptible to economic downturns.
- **Equity:** The individual income tax scores well on horizontal equity to the extent that the same rules apply to all taxpayers. Deductions, exemptions, and credits erode horizontal equity. Montana has more than 50 additions and subtractions; exemptions for age, blindness, and disabled dependents; and 31 individual income tax credits. The progressive rate structure is thought to promote vertical equity, as do some income-based tax credits such as the earned income tax credit and the elderly homeowner and renter credit.
- **Compliance and Administration:** An individual income tax is easier to comply with and administer if it is based on the federal income tax. Montana's tax is linked to the federal tax, but there are many points of departure.
- **Competition:** Citizens may consider the income tax when making location decisions, especially retirees. Montana provides a partial exemption for pension income and grants an extra exemption for those age 65 or older. Consideration of the implications of the entire tax system, not just the income tax, may be more useful.
- **Economic neutrality:** The existence of an income tax affects decisions about how much to work and invest. The federal income tax is larger and may have more impact. Deductions and credits are often designed specifically to be non-neutral and to incentivize certain desired behavior. NCSL recommends frequently evaluating non-neutral features of the income tax.
- **Accountability:** The individual income tax is fairly visible because taxpayers withhold income taxes from each paycheck or make estimated payments throughout the year, then reconcile these amounts every April.

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[7] The Legislature approved bills to revise the individual and corporate income taxes in 2013 and 2015, but the Governor vetoed the bills. Both bills aimed to simplify the Montana income tax, as did two other bills introduced in 2013 and one introduced last session by Rep. Jim Hamilton.

Montana Adjusted Gross Income (MAGI)

Federal Adjusted Gross Income (FAGI): Wages, pensions, social security, capital gain/loss, rents, royalties, business income

Montana Additions: federal NOL carryover, taxable federal refunds, interest on other states' municipal bonds, addition to federal taxable social security

Montana Subtractions: Montana NOL carryover, exempt tribal income, subtraction to federal taxable social security, active duty military salary, exempt pension income

Standard Deduction or Itemized Deductions

Standard Deduction: 20% of MAGI

- 2019 maximum: $4,710 single/MFS; $9,420 MFJ/HOH
- 2019 minimum: $2,090 single/MFS; $4,180 MFJ/HOH

Itemized Deductions: federal income taxes paid, home mortgage interest, real estate taxes, charitable contributions, medical insurance premiums, deductible medical expenses, business expenses

Personal Exemptions

$2,510 each for self, spouse, age 65 or older, blind, dependents, disabled dependents

Tax Rate

First $3,100 of taxable income: 1%
Next $2,300 of taxable income: 2%
Next $2,800 of taxable income: 3%
Next $2,900 of taxable income: 4%
Next $3,200 of taxable income: 5%
Next $4,100 of taxable income: 6%
Above $18,400 in taxable income: 6.9%

Tax Credits

31 individual income tax credits

Montana Tax Liability