Individual Income Tax Advisory Council
Final Report to Governor Judy Martz
September 16, 2002

On April 15, 2002, Governor Martz announced plans to significantly change Montana's tax structure. She proposed cutting income taxes by 10% in a manner that benefits all classes of Montana taxpayers, removing the perception that we are the highest income tax state, lowering our marginal capital gains rates, which are the highest in the region, and replacing the lost tax revenue with a tax that significantly targets non-residents. She also proposed to study whether local governments should have the option of imposing local tourist taxes.

Governor Martz appointed three advisory councils to develop specific recommendations for the three parts of this tax reform proposal: an Individual Income Tax Advisory Council, a Tourist Tax Advisory Council, and a Local Option Tourist Tax Advisory Council.

The charge to the Governor's Individual Income Tax Advisory Council was to:

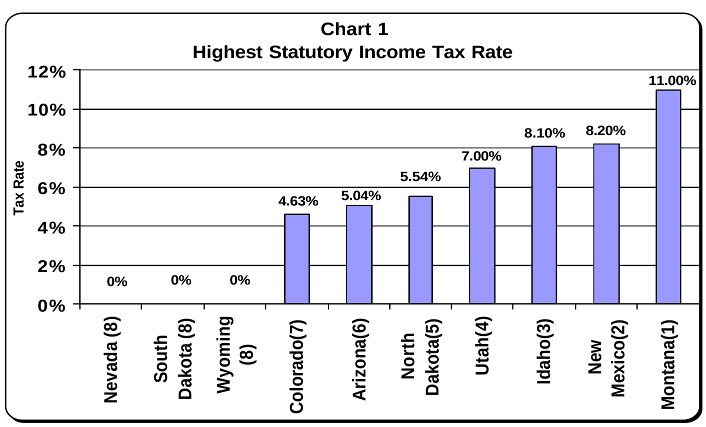
> *Recommend a proposal to reduce Montana's income tax by 10% in a manner that benefits Montana taxpayers at all income levels, reduces the top marginal rates and reduces the effective capital gains rates. To accomplish these goals, the council shall explore eliminating federal deductibility.*

The Council met four times, on May 30, June 20, July 17 and September 16. Council members are shown in *Appendix A*.

Change Imperative

A state's tax structure, if significantly out of line with that of surrounding and competing states, can impede economic development. A detailed examination of Montana's tax rates in comparison with those in other states conducted in the fall of 2001 showed that Montana's tax rates, for the most part, are competitive with respect to neighboring and other Rocky Mountain states.

The prominent exception to this general finding lies with Montana's top marginal individual income tax rate, which at 11% is not only the highest in the region (see Chart 1), but among the highest in the nation.



But Montana is one of just a few of states that allows taxpayers to fully deduct their federal income taxes. This acts to reduce Montana's *effective* tax rate below 11%. For example, in tax year 2000 a taxpayer paying federal taxes at the highest federal rate of 39.6% would pay the federal government $39.60 on the last $100 of income earned. For Montana income tax purposes this person is able to deduct this $39.60 before applying the state's top rate of 11%, which means that this person would pay the state just $6.60 on the last $100 earned, for an effective tax rate of just 6.6% ($100 – 39.60 = $60.40 X .11 = $6.60 / $100 = 6.6%). For taxpayers in the 28% federal rate bracket, the effective tax rate goes up to 7.92% ($100 – 28 = $72 X .11 = $7.92/$100 = 7.92%). These effective rates will increase as the federal rate reductions included in the Economic Growth and Tax Relief Reconciliation Act of 2001 are phased in through tax year 2006.

The fact that Montanans are able to deduct in full any federal income taxes paid during the tax year acts to reduce the *effective* tax rate paid by many taxpayers; but nevertheless leaves the *perception* of Montana as the highest income tax state to those uninitiated in the finer points of tax preparation. This, in itself, can act to prevent entrepreneurs and other business owners from locating in Montana, depriving the state of new jobs and an increase in the tax base.

Perhaps more importantly, Montana's top individual income tax rate, notwithstanding federal deductibility, results in the highest marginal tax rate on capital gains income in the region. Because the federal government's highest marginal tax rates on capital gains income are much lower than the highest marginal tax rates on "ordinary" income, *Montana's effective tax rate on capital gains income is much higher than on ordinary income!*

To illustrate, take the case of the person discussed above who this time has $100 of capital gains income rather than ordinary income. In tax year 2000 the federal maximum rate on capital gains income was 20% (rather than 39.6% for ordinary income). Therefore, this person would pay the federal government $20 on the last $100 of capital gains income. Again, this person would deduct this amount before paying state income taxes. At the state's top rate of 11% this would result in additional state tax of $8.80 ($100 – 20 = $80 X .11 = $8.80), for an effective marginal tax rate of 8.8% ($8.80/$100 = 8.8%). This effective rate will increase to 9% for some long-term capital gain income as the federal rate is reduced to 18%.

These relatively high effective rates of taxation on capital gains income can have serious adverse impacts on capital formation in the state, again depriving the state of good paying jobs and tax base.

This was reinforced by Dave Gibson, the administrations Chief Business Officer, who provided the Council with several real world examples of where taxpayers and businesses either did not consider Montana a viable place to move to, or left the state to avoid the severe tax penalties associated with one-time capital gains events.

To address these concerns, Governor Martz created the Individual Income Tax Advisory Council which has provided recommendations on how to:

- reduce the state's top marginal tax rate to a level close to the regional and national average,

- make our marginal rate of taxation on capital gains income competitive with that in neighboring and other Rocky Mountain states, and

- provide for a 10% reduction in individual income taxes that reduces average tax liability for all classes of taxpayers.

This report presents the final findings and recommendations of the Council.

Tax Reform Issues and Options

During the course of their deliberations, the Council discussed a variety of issues pertaining to reforming the individual income tax to meet the economic development goals stated in the Council charge. The major issues discussed included:

- the level to which the top marginal income tax rate should be reduced;

- whether the current law deduction for federal income taxes should be eliminated entirely, or capped at some appropriate level;

- whether there should be some preferential treatment of capital gains income, and what that treatment should be;

- and how the overall 10% reduction in tax liability should be distributed across income brackets.

In examining these issues the Council considered the trade-offs that naturally occur between equity considerations, including the by-income-bracket interaction of the income tax reduction coupled with the tourist tax increases; ease of administration, overall simplicity and taxpayer compliance; minimizing the number of taxpayers that would experience a tax increase under any reform proposal; and the best approaches to marketing Montana's tax structure.

These issues and other considerations are discussed in greater detail in the following sections.

Top Marginal Tax Rate

The Council agreed that Montana's current top marginal tax rates of 9 - 11% provide an impediment to economic development through the perception they create of Montana being the highest individual income tax state. It was noted that in order to bring this rate more into alignment with rates in the region that the top rate should be reduced to something below 7%.

Early on, it was suggested that the top rate should be reduced to 6.75%, which is the flat rate applied to corporate income in Montana, to eliminate much of the current planning now required to determine the most beneficial form of business ownership when operating a business in Montana. This would provide for equal marginal rates of taxation regardless of whether the form of business ownership was corporate or some form of "pass-through" ownership in which individual owner shares are subject to the individual income tax.

It was noted that the cost between a top rate of 6.9% and 6.75% was about $8 million. Several members of the Council noted that the $8 million could be used to provide for additional capital gains reductions, could be used to provide additional relief to the low end of the income scale to offset increases on those taxpayers from the tourism tax, and that from a marketing point of view there was not much difference between a rate of 6.9% and 6.75%.

After fully discussing the matter, the Council came to consensus that the top rate should be reduced to 6.9%.

Eliminate or Cap the Deduction for Federal Income Tax

The Council agreed that there were significant trade-offs between eliminating the current law deduction for federal income taxes, and capping that deduction at an appropriate level.

There were concerns that capping the deduction would continue misconceptions about the state's effective income tax and capital gains rates for those taxpayers whose incomes resulted in federal tax liabilities below the cap amount. It was also noted that full elimination of the deduction would add a greater degree of simplification to the overall tax system than retaining a cap on the deduction.

On the other hand, federal deductibility is the largest, and in some cases the only, deduction available to most low- and middle-income households; particularly those who have paid off their homes. One Council member argued that without some cap provision it could become politically difficult to sell the proposal.

More importantly, however, providing for a reasonable cap on federal deductibility acted to greatly reduce the number of households and taxpayers that experienced an increase in tax liability under any of the alternative options presented and discussed. It was this benefit that capping had on the number of households and taxpayers who would lose under any of the options discussed that ultimately swayed the Council in favor of retaining a cap on federal deductibility. The Council further agreed that capping federal deductibility at $5,000 ($10,000 if married and filing a joint income tax return) was appropriate.

Tax Treatment of Capital Gains Income

The Council members generally acknowledged that Montana's current tax treatment of capital gains income often acts to move people out of the state, particularly when the capital gains income is a one-time occurrence that subjects the taxpayer to Montana's highest marginal rates. It becomes very beneficial for the taxpayer to take up residence in a nearby state that has no state income tax (such as Nevada or Wyoming) in order to avoid the Montana tax bite on a one-time capital gains transaction.

The Council agrees that reducing Montana's top marginal tax rate from 11% to 6.9% by itself would act to reduce the effective tax rate on capital gains income. However, the sentiment among Council members was that preferential treatment of capital gains income – in order to provide an incentive for keeping taxpayers in the state, to induce capital formation, and to enhance economic development in general – should be a high priority. This concern warranted examining additional preferential tax treatment for capital gains income, provided that treatment was affordable and did not result in an extremely disproportionate benefit to any particular class of taxpayer.

The Council members examined and discussed three alternative approaches to providing for preferential tax treatment for capital gains income:

- provide for an *exclusion* of capital gains income;
- provide for a *top marginal rate* of taxation on capital gains income below the top rate applied to "ordinary" income; and
- provide taxpayers with a nonrefundable capital gains income tax *credit*.

The Council noted that although capital gains income is received by taxpayers in virtually every income bracket, it is highly concentrated in the upper income brackets. It was also noted that a large capital gains event, such as the sale of a business, farm or ranch, can cause a middle-income taxpayer to be taxed one year in the upper income brackets. With respect to capital gains income, the Council narrowed the focus to alternative proposals that would provide either:

- a top marginal rate of 5% on capital gains income,
- a 30% exclusion of capital gains income, or
- a tax credit equal to 1% of capital gains income.

In their deliberations, Council members discussed and debated several different features of alternative approaches to providing preferential treatment for capital gains income. It was noted that both the 30% exclusion and the 1% credit would provide a benefit to virtually all taxpayers across all income brackets who had capital gains income, whereas the proposal to cap the top marginal rate on capital gains at 5% would benefit only those households whose marginal tax rates would otherwise be greater than 5% under the proposed law rate table. This latter approach concentrated more of the benefit from preferential treatment of capital gains income in the higher income brackets.

One Council member pointed out that a 1% capital gains tax credit would effectively reduce the top marginal tax rate on capital gains income to 5.9%, given a top rate of 6.9% on ordinary income. This represents about a 15% reduction on capital gains income for taxpayers in the highest income bracket under the proposed tax rate schedule. On the other hand, a 1% capital gains tax credit results in a 50 - 100% reduction in tax on capital gains for taxpayers in the very lowest taxable income brackets under the proposed law tax rate schedules endorsed by the Council.

Members of the Council also suggested that either the 1% credit or the top marginal rate of 5% approach would make for better marketing of the state's tax system, whereas an exclusion of capital gains income would not be as effective a marketing tool. Of the three approaches, it was further noted that the top marginal rate approach would be the most complicated to administer and compute for the taxpayer.

Finally, of the three options, the 1% credit was the least expensive, costing around $12 million in tax year 2000. (Capping the top rate on capital gains at 5% would have cost an additional $16.4 million, whereas the 30% exclusion would have cost almost $23 million, *after the proposed law tax rate tables with a top marginal rate of 6.9% were assumed to be in place*.)

Based on the above discussions and considerations, it was the consensus of the Council that the preferred approach to providing for preferential capital gains treatment is the 1% credit approach.

The impact that the Council's recommendations have on the effective marginal tax rate applied to capital gains income is provided in *Appendix D*. But first, a brief explanation of what these particular tax rates represent is warranted.

Taxpayers and businesses looking to locate or relocate their business or personal residence are influenced by tax rates they face in different locations. Effective tax rates from state to state are influenced by both the state's tax code and how that tax code interacts with federal income tax laws. While the federal code allows all taxpayers to deduct their state income taxes when figuring federal tax liability, most states do not allow their taxpayers to fully deduct federal taxes when figuring their state taxes. Some states allow a partial deduction of federal taxes, and yet other states that strictly tie to the federal definition of allowable itemized deductions inherently allow a deduction for their own state income taxes when figuring their state income taxes. This wide array of deductibility options results in a variety of complicated formulas designed to provide tax practitioners with effective tax rates depending on the interaction of a particular state's tax code with that of the federal government. Generally speaking, these effective tax rate formulas depend on 1) the state marginal tax rate on ordinary income; 2) the state marginal tax rate on capital gains income; 3) the federal marginal tax rate on ordinary income; and 4) the federal marginal tax rate on capital gains income. It becomes very technical and complicated, so the experts did the math for the Council.

What *Appendix D* shows is the *combined federal/state effective marginal tax rate on ordinary and capital gains compared to a state like Wyoming*, which has no income tax. These are the tax rates that many taxpayers face when deciding which state with an income tax to locate in. The impact that the Council's recommendations have on Montana's effective rates is shown on the first page of *Appendix D*, and is summarized in Table 1, following. It should be noted that some taxpayers with unpredictable income are not able to maximize their federal deductibility and actually experience higher tax rates.

With respect to *ordinary income*, the Council's recommendations would reduce the effective marginal tax rate by 18.6% to 7%, depending on the taxpayer's federal marginal rate on ordinary income, regardless of whether the 1% capital gains credit is included in the proposal or not.

Under the Council's recommendation that **does not include any preferential capital gains treatment (Option A)**, the effective marginal rate on *capital gains income* would be reduced by 23.7% to 26.4% depending on the taxpayers federal marginal rate on ordinary income, and whether capital gains is taxed at a maximum rate of 20% or 18% (effective first in tax year 2006) at the federal level.

Finally, under the Council's recommendation that **includes a 1% capital gains credit (Option B)**, the effective marginal rate on *capital gains income* would be reduced by 34.8% to 37% depending on the taxpayers federal marginal rate on ordinary income, and whether capital gains is taxed at a maximum rate of 20% or 18% (effective first in tax year 2006) at the federal level.

Table 1
Change in Combined Federal/State Marginal Individual Income Tax Rates
On Ordinary and Capital Gains Income - TY2006

	Federal Marginal Rate on Ordinary Income			
	25%	**28%**	**33%**	**35%**
A. Marginal Rate on Ordinary Income - Options A and B				
Current Law (11%)	6.4%	5.9%	5.1%	4.8%
Proposed Law (6.9%)	5.2%	5.0%	4.6%	4.5%
% Change	**-18.6%**	**-15.5%**	**-9.8%**	**-7.0%**
B. Marginal Rate on Capital Gains Income (20% Federal Rate) - Option A				
Current Law (11%)	6.8%	6.5%	6.1%	6.0%
Proposed Law (6.9%)	5.2%	5.0%	4.6%	4.5%
% Change	**-23.7%**	**-24.0%**	**-24.5%**	**-24.5%**
C. Marginal Rate on Capital Gains Income (20% Federal Rate) - Option B				
Current Law (11%)	6.8%	6.5%	6.1%	6.0%
Proposed Law (5.9%)	4.4%	4.3%	4.0%	3.8%
% Change	**-34.8%**	**-35.0%**	**-35.5%**	**-35.5%**
D. Marginal Rate on Capital Gains Income (18% Federal Rate) - Option A				
Current Law (11%)	7.0%	6.7%	6.3%	6.1%
Proposed Law (6.9%)	5.2%	5.0%	4.6%	4.5%
% Change	**-25.6%**	**-25.8%**	**-26.3%**	**-26.4%**
E. Marginal Rate on Capital Gains Income (18% Federal Rate) - Option B				
Current Law (11%)	7.0%	6.7%	6.3%	6.1%
Proposed Law (5.9%)	4.4%	4.3%	4.0%	3.8%
% Change	**-36.4%**	**-36.6%**	**-37.0%**	**-37.0%**

Appendix D shows how Montana's effective marginal tax rate rank (with the highest rank rated 1st) would shift relative to nine other western states with an income tax. Under current law, Montana's effective marginal tax rate on *ordinary income* ranks 3rd, 4th, or 5th highest, depending on the taxpayer's federal marginal rate on ordinary income. Under the Council's recommendations this would drop to 5th regardless of the taxpayer's federal marginal rate on ordinary income.

With respect to *capital gains income*, *if the federal marginal rate is 20%*, Montana's rank drops from 2nd to 5th under recommendations that do not include any preferential capital gains treatment; but drops to 6th if the recommendations include the 1% capital gains credit, regardless of the taxpayer's federal marginal rate on ordinary income.

If the federal marginal rate is 18%, Montana's rank generally drops from 1st to 5th under recommendations that do not include any preferential capital gains treatment; but drops to 6th if the recommendations include the 1% capital gains credit.

As stated earlier, it was the consensus of the Council that the preferred approach to providing for preferential capital gains treatment is the 1% credit approach. However, the Council also recognized that the impact analyses being provided to the Council were based on tax year 2000 individual income tax return data, and that tax year 2000 was likely to be an extraordinary year with respect to capital gains income, relative to coming years.

In Montana, from 1996 to 2000 capital gains income reported on individual income tax returns more than doubled, growing from $616 million to $1.26 billion. The Congressional Budget Office, DRI-WEFA, and other states have indicated that they believe capital gains realizations reported on income tax returns could drop as much as 50% between tax year 2000 and 2001. A preliminary reading of the tax year 2001 Montana tax returns indicates a drop of 50% in Montana realizations before counting capital gains reported on returns filed on extensions.

Given these considerations, the Council believes that the administration should wait until tax year 2001 income tax information is available from the Department of Revenue. If that information shows a significant reduction in capital gains income between tax year 2000 and tax year 2001, then the final recommendation for a 10% tax cut should include provisions for a capital gains tax credit of 1%.

Distribution of Tax Relief

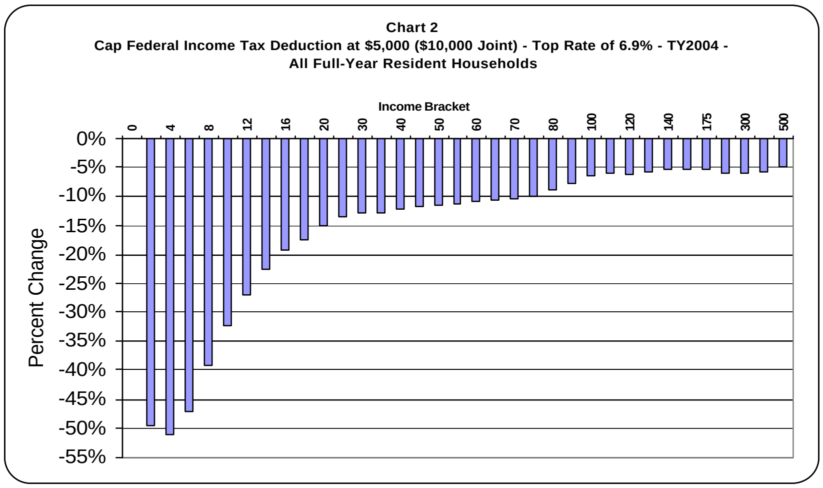
The Governor's charge to the Council was to provide for an overall 10% reduction of individual income tax liability "in a manner that benefits Montana taxpayers at all income levels". The Council agreed that this does not necessarily mean that every taxpayer would receive a 10% cut in tax; nor would the average tax reduction in every income bracket necessarily be 10%.

The Council noted that there is a trade-off between providing a 10% reduction for every income bracket, and minimizing the number of taxpayers with a tax increase. Generally, the number of taxpayers who would experience a tax increase is reduced if the proposal does not provide for a 10% reduction in every tax bracket. This is due in part to the fact that the number of taxpayers tends to be clustered in lower income brackets.

The Council also agreed that the income tax proposal should be constructed in such a manner that when the tax decreases from the income tax proposal are combined with the average tax increase on Montana residents from the tourist tax proposal, no income bracket experiences more than a nominal increase in average net tax liability. This is illustrated in *Appendix E*, which shows the combined change in tax liability from the income tax proposal (without any preferential treatment for capital gains), and the tourist tax proposal.

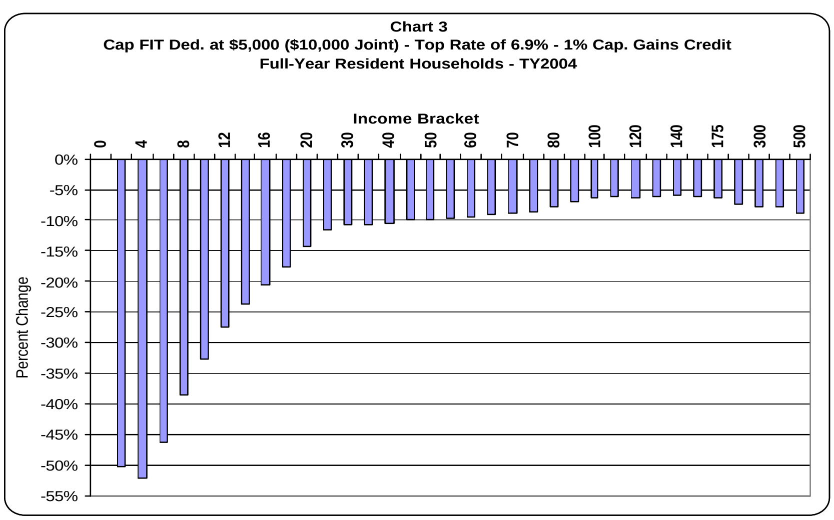
In order to achieve this result it was the Council's consensus that the *percentage* reduction in tax liability under the income tax proposal should be substantially larger in the very lowest income brackets, and gradually reduced as incomes rise.

Appendix B provides detailed impacts of the Council's final proposal *without any preferential treatment of capital gains income*. Chart 2 shows the tax year 2004 forecast percentage reduction in tax liability by income bracket under that proposal.



Percentage reductions range from around 50% in the very lowest income brackets; fall to 10 - 15% for households with incomes between $20,000 and $75,000; and drop to around 5 - 6% for households with incomes above $110,000.

Appendix C provides detailed impacts of the Council's final proposal *including a 1% capital gains tax credit*. Chart 3 shows the tax year 2004 forecast percentage reduction in tax liability by income bracket under that proposal.



In general, the overall pattern of reductions is similar to that in the proposal that has no preferential capital gains treatment. However, percentage reductions for households with incomes ranging from $20,000 to $110,000 are slightly lower, whereas percentage reductions for households with incomes above $110,000 are higher than under the option with no preferential capital gains treatment. Providing for the capital gains preference shifts some of the overall tax benefit away from middle income households to higher income households.

Summary of Recommendations

It is the general consensus of the Governor's Individual Income Tax Advisory Council that the following recommendations be made with respect to the charge given the Council:

- The top marginal tax rate for the Montana individual income tax should be reduced from its current level of 11% to 6.9%.

- The current law deduction for federal income taxes paid should be capped at $5,000 ($10,000 if married and filing a joint tax return).

- The administration should consider including in any proposed individual income tax reform legislation a tax credit equal to 1% of the taxpayer's capital gains income, if the information from tax year 2001 individual income tax returns indicates that the cost of this proposal does not substantially prohibit achieving any of the other stated goals and objectives included in the Governor's charge to the Council.

- The total amount of tax relief provided through a 10% reduction in individual income taxes should be distributed across income brackets in a manner that ensures that no taxpayer income class experiences more than a nominal increase in tax when the tax increase effects of the tourist tax are combined with the individual income tax reduction.

Bob DePratu Chairman

Kurt Alme Vice Chairman

List of Appendices