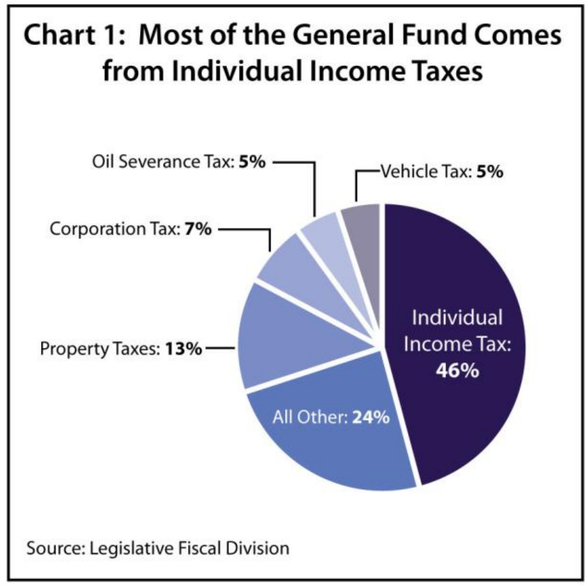
Policy Basics
April 2012

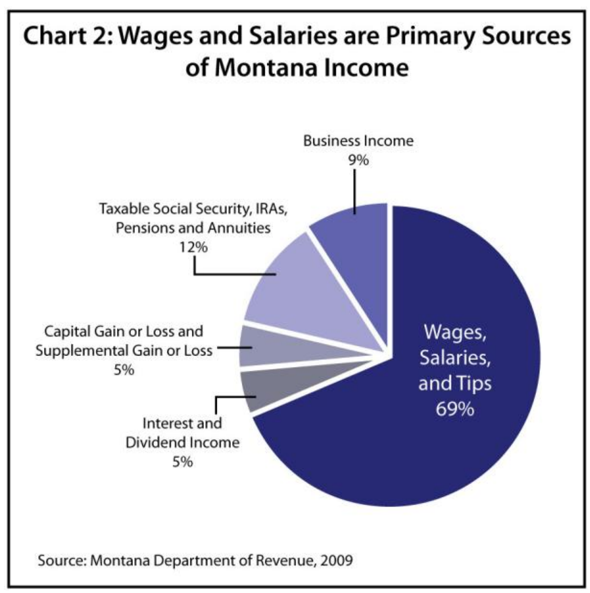
Introduction to Montana's Individual Income Tax

For generations, our tax dollars have served as shared investments in the programs and services that make our state a great place to live, work, and play. Tax dollars enable Montanans to work together for those things which we could not achieve alone - educate our children, build and maintain infrastructure, provide public safety through policy and fire protection, keep our air and water clean, and pave the way to a strong economy where every Montanan can thrive.

In Montana, these shared investments are managed through the state's "general fund." Taxes make up the vast majority (84%) of the revenue for the General Fund,[1] and the individual income tax is the single largest source of revenue for the general fund, comprising nearly half of the state's tax revenue (Chart 1).



Taxes paid on wages, salaries, and tips made up 68% of income subject to individual income tax (Chart 2). In general, taxes paid by corporations are paid through the corporate income tax. However, depending on how the entity is structured, business income may actually be reported through the individual income tax. Specifically, if the business is structured as a C corporation in order to receive the legal benefits associated with such a status (including limited liability for debts and business actions and access to capital markets), its taxes would be classified as corporate taxes. All other businesses, including sole proprietorships, partnerships, limited liability corporations, and S-corporations, report income on individual returns. Taxes on business income make up just 9% of total income subject to individual income



Policy Basics is a series of background reports on issues related to the Montana budget and Montana taxes. The purpose of the Policy Basics series is to provide the public, community advocates, and policy makers the tools they need to effectively engage in important fiscal policy debates that help shape the health and safety of our communities.

taxes.

2003 Changes to the Montana Income Tax

In 2003, the Montana Legislature made significant and harmful changes to our income tax system. That year, legislators passed SB407, a bill that greatly altered Montana's tax system. The changes made by SB407 included collapsing the income tax brackets and creating a credit for capital gains income. Both of these provisions make our tax system more regressive and cost the state revenue that could be used to invest in our future.

Key Terms

Progressive – refers to a tax or a tax system in which higher-income households pay a larger portion of their income in taxes compared to those households with lower incomes.

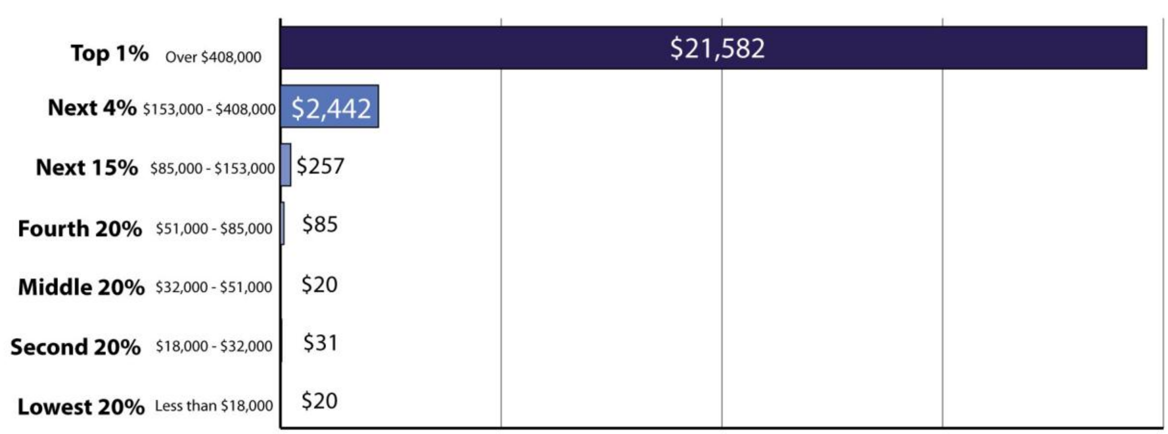
Regressive – refers to a tax or tax system in which lower-income households pay a larger portion of their income in taxes compared to those households with higher incomes.

Bracket Collapse

Prior to passage of SB407, Montana had ten different income brackets, with each higher income bracket paying a slightly larger share of their income in taxes (Appendix A).[2] In this old structure, the lowest income bracket paid 2% of their income in taxes, while the highest bracket (applying to incomes over $80,300) paid 11% of their income in taxes.

The changes in SB407 reduced the total number of income brackets to six. The new top bracket included all households making over $13,900.[3] According to the new law, each of these households pays 6.9% of their income in taxes. As a result, many taxpayers experienced an overall reduction in their tax rate. The wealthiest Montanans experienced the greatest reductions. The top 1% of taxpayers received an average tax cut of $21,582. For the bottom 60% of taxpayers, the average tax cut was just $24 (Chart 3).

Chart 3: Wealthiest 1% of Montanans Benefit the Most from Bracket Collapse



Source: Institute on Taxation and Economic Policy, 2012

As a whole, the bracket collapse has created a less progressive income tax structure. In fact, while our income tax system remains somewhat progressive, it is not progressive enough to offset the regressivity of our property taxes and selective sales and excise taxes.[4] In other words, when looking at the entire tax system in Montana, lower-income taxpayers pay a larger portion of their income in taxes compared to those with higher incomes. The changes made have also had a negative impact on Montana's revenue streams. In 2012, it is estimated that the bracket collapse will cost the state $185 million.[5] This lost revenue could have been used to educate our children, keep our communities safe, and protect our land and water instead of reducing taxes for those who need it the least. For further information about the income tax bracket collapse, see Montana Budget and Policy Center's report, Income Tax Bracket Collapse is Costing Montana.

Capital Gains Credit

Currently, Montana is one of only eight states that offer significant tax breaks for capital gains.[6] The capital gains credit has proven to be unaffordable, is unfair to Montanans who earn income through wages, and has not benefited the Montana economy.

The capital gains credit lowers the effective tax rate for people who earn income through investments compared to those who earn income from wages. This creates a tax system that favors wealth over work. Ninety-four percent of the benefits from the credit go to the top 20% of taxpayers, while a mere 6% go to the bottom 80%.[7]

The average tax cut from the credit for the top 1% is $3,401. While the average tax cut for the bottom 80% is less than $12. Middle and lower income Montanans do not benefit from the credit because they are much more likely to earn their income on the job rather than through the sale of large assets. In fact, the assets owned by most Montanans—primary residences and retirement funds – are not treated as capital gains income when they are sold.

> **Key Term**
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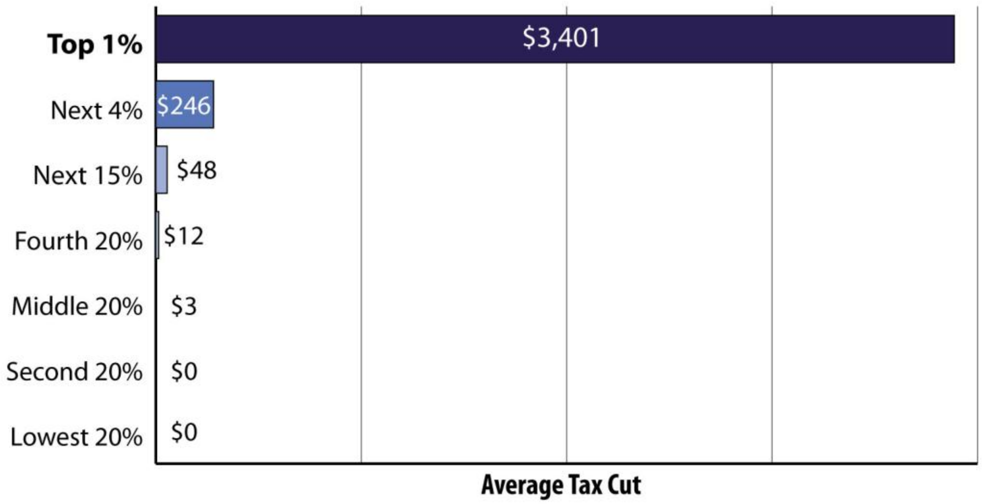
> **Capital Gains** – Capital gains are income from the sale of an asset, such as stocks, bonds, vacation homes, art, a business, etc. Capital gains income is only "realized" when the asset is sold for a profit. As long as the investor continues to own the asset, any increase in value is not considered income. Capital gains are taxed only when the asset is sold. The first $500,000 in capital gains from primary residences is not taxed. Likewise, profits from the sale of an individual retirement account are not treated as capital gains.

Economic theory and experience teach us that treating capital gains more favorably than wages will not help the economy. In fact, the lost tax revenue could actually prevent growth by forcing state budget cuts. The capital gains credit cost Montana an estimated $26 million in 2011.[8] These vital dollars could have been used to fund growth-oriented services like education, healthcare and environmental protections. For further information see Montana Budget and Policy Center's report, Ending Preferential Treatment of Capital Gains Income.

Chart 4: Wealthiest 1% of Montanans Benefit the Most from Capital Gains Credit



Source: Institute on Taxation and Economic Policy, February 2011

Montana's Income Tax Threshold

In Montana, our income tax system makes it even harder for many low-income, working families to provide for their basic needs. By all measures, our income tax structure places one of the highest burdens in the nation on families living in poverty. Montana begins taxing a two-parent family with two children at a lower annual income than any other state in the country. We begin taxing such a family when their income reaches $12,500 per year, which is over $10,000 below the federal poverty line.[9] For a single-parent family with two children, we begin taxing at a lower income than all other states except Alabama and Illinois.

> **Key Term**
>
> **Income Tax Threshold** – The income tax threshold is the amount of family income at which a household first begins to owe income taxes.

We also tax the income of workers living in poverty at a higher rate than most other states. Only four other states levy a higher tax on a single parent with two children living in poverty.[10] This family would owe an average of $162 per year in Montana.

Most states do not impose income taxes on families living below the federal poverty line.[11] In fact, twenty-three states (and the District of Columbia) have enacted state earned-income tax credits to supplement the income of working families who fall below the poverty line.[12] Montana could substantially improve the tax treatment of low-income families by implementing a state Earned Income Tax Credit. For more information see Montana Budget and Policy Center's report, Investing in Montana's Working Families: A Montana Earned Income Tax Credit (EITC).

Deduction for Federal Taxes Paid

Montana is one of just six states that still has a deduction for federal income taxes paid, a deduction that disproportionately benefits the highest income earners in the state and costs the state much-needed revenue.[13]

The deduction for federal taxes paid is an unusual tax break that allows taxpayers to deduct the federal taxes they pay from their Montana taxable income. The deduction is only available to those who utilize itemized deductions and is capped at $5000 for single ($10,000 for married) taxpayers.[14] This deduction was implemented in 1933 and no longer makes sense for Montana.[15] In 2009, this deduction cost over $50 million.[16]

Reforms for a Stronger Montana

Our income tax system is one of the primary ways that we pool our resources to make investments in public services and infrastructure that help make our communities stronger, safer, healthier, and more prosperous. The following reforms would greatly strengthen Montana's income tax system:

- Repealing the capital gains credit,
- Restoring the income tax brackets,
- Disallowing a deduction for federal taxes paid, and
- Implementing a state Earned Income Tax Credit.

Montana needs a modern income tax system that makes continued investment in our communities and economy, paving the way for a more prosperous future for our children and grandchildren.

Appendix A: Effects of 2003 Tax Changes on Income Tax Brackets and Rates

Before Bracket Collapse					After Bracket Collapse				
Tax Brackets and Rates					Tax Brackets and Rates				
If your taxable income is					If your taxable income is				
At least	But less than	Then your tax is:		Less:	At least	But less than	Then your tax is:		Less:
0	2,300	2%	of taxable income		0	2,300	1%	of taxable income	
2,300	4,600	3%	of taxable income	-23	2,300	4,100	2%	of taxable income	-23
4,600	9,200	4%	of taxable income	-69	4,100	6,200	3%	of taxable income	-64
9,200	13,800	5%	of taxable income	-161	6,200	8,400	4%	of taxable income	-126
13,800	18,400	6%	of taxable income	-299	8,400	10,800	5%	of taxable income	-210
18,400	22,900	7%	of taxable income	-483	10,800	13,900	6%	of taxable income	-318
22,900	32,100	8%	of taxable income	-712	13,900		6.90%	of taxable income	-443
32,100	45,900	9%	of taxable income	-1033					
45,900	80,300	10%	of taxable income	-1492					
80,300		11%	of taxable income	-2295					

Source: Montana Department of Revenue for Tax Years 2004 and 2005.

[1] Montana Legislative Fiscal Division, "State General Fund Revenues," Fiscal Year 2011, http://www.leg.mt.gov/css/fiscal/reports/Revenues-GF.asp.

[2] These brackets correspond to varying amounts of taxable income. Taxable income is income after deductions and exemptions have been subtracted. For example, in 2011, a family of four taking the standard deduction and four personal exemptions could deduct up to $16,980 from their gross income to arrive at taxable income. Montana Department of Revenue, "Montana Individual Income: Tax Year 2011," http://revenue.mt.gov/content/formsandresources/current_year_downloadable_forms/2011_Forms/Individual_Income_tax_Forms/2011_IIT_Tables.pdf.

[3] This figure is adjusted each year for inflation.

[4] Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in all 50 States," November 2009.

[5] Institute on Taxation and Economic Policy, "Return to Pre- SB407 Rates," 2010.

[6] Institute on Taxation and Economic Policy, "Who Pays? A Distributional Analysis of the Tax Systems in all 50 States," November 2009.

[7] Institute on Taxation and Economic Policy, "Impact of Repealing Montana's Capital Gains Tax Credit in Tax Year 2011," 2012.

[8] Institute on Taxation and Economic Policy, "Impact of Repealing Montana's Capital Gains Tax Credit in Tax Year 2011," 2012.

[9] Phil Oliff and Nicholas Johnson, "The Impact of State Taxes on Low-Income Families in 2011," Center on Budget and Policy Priorities, November 15, 2011, http://www.itepnet.org/pdf/pb51fedinc.pdf.

[10] Ibid.

[11] Ibid.

[12] "Policy Basics: State Earned Income Tax Credits," Center on Budget and Policy Priorities, Revised January 13, 2011, http://www.cbpp.org/files/policybasics-seitc.pdf.

[13] Institute on Taxation and Economic Policy, "Why States That Offer the Deduction for Federal Income Taxes Paid Get it Wrong," August 2011, http://www.itepnet.org/pdf/pb51fedinc.pdf.

[14] Montana Department of Revenue, "Biennial Report: July 1, 2008- June 30, 2010," December 2010, http://revenue.mt.gov/publications/biennial_reports/default.mcpx.

[15] Institute on Taxation and Economic Policy, "Why States That Offer the Deduction for Federal Income Taxes Paid Get it Wrong," August 2011, http://www.itepnet.org/pdf/pb51fedinc.pdf.

[16] Montana Department of Revenue, "Tax Expenditures" in Biennial Report: July 1, 2008- June 30, 2010, December 2010, http://revenue.mt.gov/content/publications/biennial_reports/2008-2010/BiennialReport-TaxExp.pdf.