Information Request

MONTANA Department of REVENUE

Memorandum

To: Senator Cohenour

From: Aaron McNay, Tax Policy and Research

Date: March 31, 2021

Subject: SB 399 Distributional Impacts

Question:

You have requested information on the impacts associated with the proposed changes to Montana's personal income tax made in SB 399.

Answer:

SB 399 makes several large changes to Montana's personal income tax. These changes can be broken down in to three main categories. The first change made by SB 399 is to modify how taxpayers determine how much of their income is subject to the state's income tax. The second is a change in the tax rates applied to the portion of income that is considered taxable. The third category of changes is the elimination of several income tax credits, the most significant of which is the states 2% capital gains income tax credit. The sections below provide a detailed explanation of the three changes, with a final section in the end which provides the combined impact.

Determining Montana Taxable Income

Under current law, determining which portion of a taxpayer's income is subject to the state's income tax starts with Federal Adjusted Gross Income (FAGI). This amount is based on the income amounts reported by the taxpayer when determining their federal income tax. FAGI includes taxable income from wages, salaries, retirement income, business income, capital gains income, Unemployment Insurance income, and any other source of income that is taxable at the federal level. FAGI also includes federal income deductions which do not require taxpayer to itemize their deductions. These "above-the-line" deductions include deductions for educator expenses, student loan interest, moving expenses for members of the Armed Forces, and several others.

After FAGI is determined, taxpayers must determine their Montana Adjusted Gross Income (MAGI). This process involves the addition of income that is taxed at the state level but is not taxed by the federal government. These additional income sources include income from interest on other states' municipal bonds, dividend income not included in FAGI, and adjustments to taxable Social Security income. The re-capture of non-qualified withdrawals of funds from Montana's first-time homebuyer accounts and medical savings accounts are included in this section. There are approximately 15 additions currently listed on Montana's personal income tax return, with more than $800 million in income added onto FAGI.

Next, taxpayers remove income that is taxed at the federal level, but not at the state level. These subtractions include income amounts the federal government does not allow states to tax, such as Railroad Retirement income. It also includes income the state has decided not to tax, such as deposits into qualifying Family Education Savings Accounts, a portion of qualifying pension income, and the capital gains income from the sale of eligible mobile home parks. In tax year 2019, there were approximately 36 of these reductions, with approximately $1.8 billion in income reductions. The removal of these reductions, and the inclusion of the additions, to FAGI determines a taxpayer's MAGI.

Once taxpayers have determined their MAGI, they then determine their Montana Taxable Income (MTI). To determine their MTI, taxpayers first remove any deductions allowed by the state from their MAGI. Taxpayers can either claim the state's standard deduction, or they can claim Montana itemized deductions. The state's standard deduction is based on 20% of the taxpayers MAGI, with a minimum and maximum deduction amount that is based on the taxpayer's filing status. The state's itemized deductions include several of the federal government's itemized deductions, but with several Montana specific ones added in. Montana specific itemized deductions include the state's deduction for federal income taxes paid, medical insurance premiums and Montana light vehicle registration fees.

Next, taxpayers determine their personal exemption amounts. Taxpayers in Montana are currently allowed to claim several personal income exemptions. Each taxpayer on the return, and each of their dependents, allow the taxpayer to claim an income exemption. Taxpayers who are at least 65 years old, or are blind, are able to claim an additional exemption.

To determine their MTI, taxpayers remove their allowed deduction amount and personal exemption amounts from their MAGI. This MTI amount is the income that is subject to the state's personal income tax and is taxed at the income tax rates.

Under SB 399, this process is changed, with taxpayers determining their MTI from their Federal Taxable Income (FTI) and not their FAGI. The move to FTI means that federal deductions and exemptions have already reduced the amount of income that is considered taxable. Because of this, SB 399 eliminates Montana's standard and itemized deductions. It also eliminates the state's personal income exemption for all taxpayers below the age of 65. SB 399 keeps an income exemption of $5,500 for each taxpayer who is at least 65 years old.

SB 399 also eliminates several of the income sources that are exempt from Montana's personal income tax. Under the proposed law, taxpayers would no longer be able to exempt income from sources such as Unemployment Insurance, qualifying pension income, gains from the eligible sale of mobile home parks, deposits into Montana's first-time homebuyer savings accounts, and several others. At the same time, the bill creates a new type of exempt income, which is 30% of a taxpayer's net-long term capital gains. The bill also requires taxpayers to add back any Qualified Business Income (QBI) deduction reported by the taxpayer in their FTI when determining their MTI.

Overall, the changes made by SB 399 for how MTI is determined has several implications. First, at their current levels, the federal standard deduction is larger than Montana's current standard deduction and personal exemption. This means that the taxable income of most taxpayers who claim Montana's standard deduction under current law would have their MTI decrease under SB 399. For example, a married household with no dependents filing a joint return could claim a standard deduction and personal exemption amount of $14,700 in tax year 2020. At the same time, the federal standard deduction for taxpayers filing a joint return was $24,800, with no personal exemptions. Under SB 399, these taxpayers would have an additional $10,100 in income excluded from the state's income tax.

For taxpayer who itemize their deductions, the impacts of the changes made by SB 399 are less clear. The elimination of the state's personal exemption would increase the MTI of taxpayers who continue to itemize their deductions. In addition, the elimination of Montana specific itemized deductions would also increase the MTI of taxpayers who continue to itemize. However, the increase the standard deduction could allow taxpayers to move from itemizing their deductions to the standard deduction. This move could offset the impacts associated with the other changes. Two examples are provided below to see the different impacts of the changes for taxpayers who itemize their deductions.

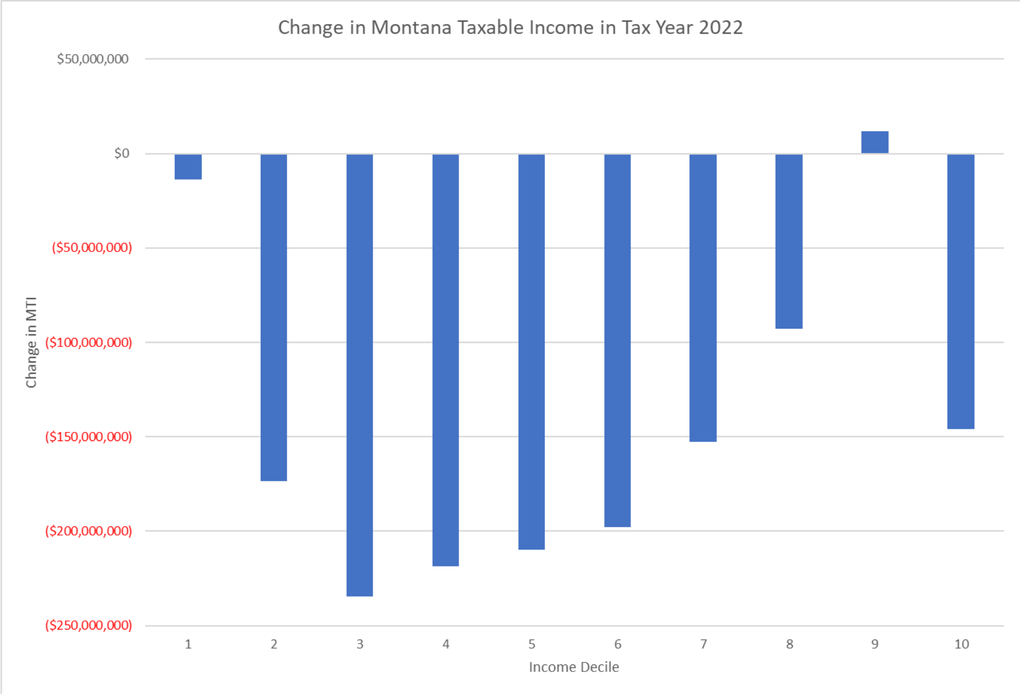
For the first example, a married household with no dependents file a joint return and claim $11,000 in itemized deductions under current law. With $5,120 in Montana personal exemptions in tax year 2020, the taxpayers would be able to reduce their taxable income by $16,120. With the changes made by SB 399, the taxpayers be able to claim the standard federal deduction of $24,800. Under SB 399, the MTI of these two taxpayers would decrease by $8,680.

For the second example, a similar married household with no dependents file a joint return and claim $40,000 in Montana itemized deductions. With $5,120 in personal exemptions, the taxpayers would be able reduce their MTI by $45,120. Under SB 399, the taxpayers would only be able to receive the federal itemized deduction. With no deduction for federal income taxes paid, the taxpayers are only able to deduct $30,000 in income. The changes made by SB 399 would increase the MTI of these taxpayers by $15,120.

The reduction in the types of income that are not subject to Montana's personal income tax will, holding everything else unchanged, increase the taxable income of any taxpayer who reported income from one of the eliminated income sources. For example, a taxpayer who reported $8,000 in exempted pension income under current law would have their taxable incomes increase by $8,000 under SB 399. At the same time, taxpayers who report net-long term capital gains would have their taxable incomes decrease under the proposed bill, due to the 30% income exemption. For taxpayers that receive the QBI deduction at the federal level, the add back created by SB 399 will not have an impact to their MTI under the proposed bill, as that deduction is not allowed for Montana's income tax under current law.

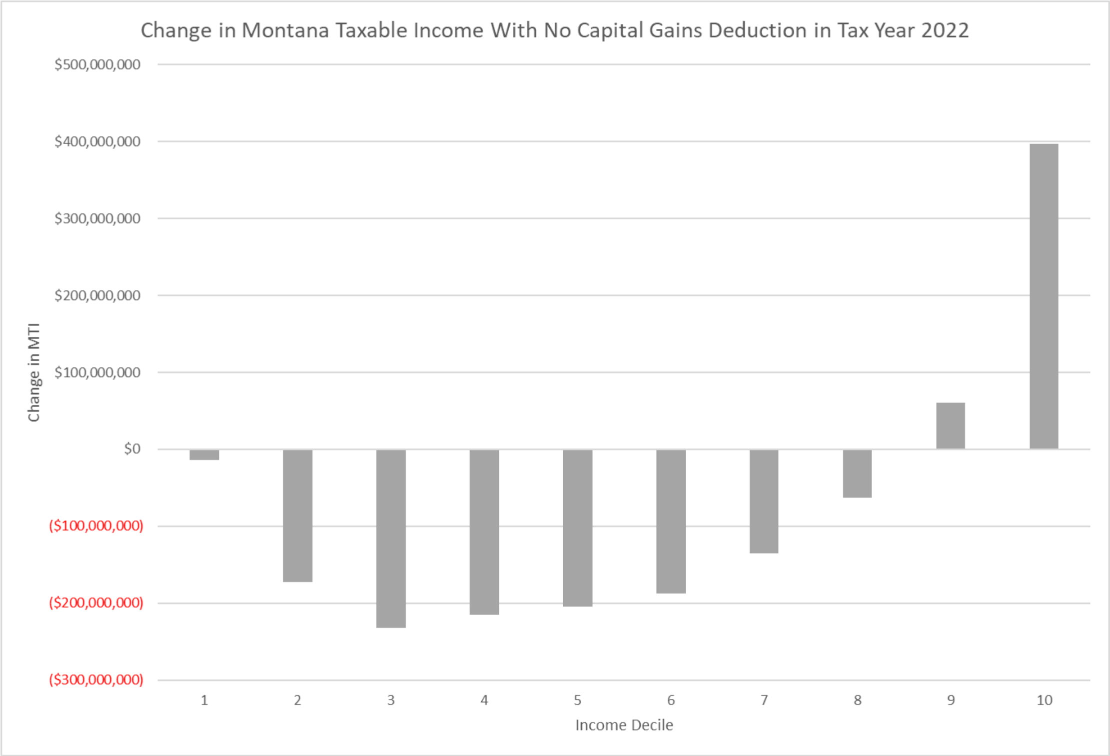
Using tax year 2019 income tax returns, and the forecast assumptions used in HJ 2, the MTI of full-year residents was estimated under current law and SB 399 for tax year 2022. The returns were grouped together into income deciles based on their forecasted household income.

The graph below provides the estimated change in Montana taxable income for each of the income deciles. As can be seen in the chart, the combined change in taxable income is negative for nearly every income decile. The change is largest for households in the third income decile, with the change getting smaller as household income increases. This pattern continues until the top income decile, where taxable incomes decrease again. The only income decile with a combined increase in their taxable income under SB 399 are households in the ninth decile.



When examining the changes in Montanan taxable incomes, the general pattern is that the change in incomes decreases as incomes increase, with households in the ninth decile actually expected to have their taxable incomes increase slightly under the proposed bill. Households in the top income decile seem to deviate from this trend, however. The large decrease in combined taxable incomes for households in the top decile is due to the 30% capital gains income deduction created by SB 399. Without this exemption, the taxable income of households in the top decile would increase by nearly

$400 million. The table below includes all the changes made to taxable incomes under SB 399, except for the capital gains deduction. It is important to note, however, that the state's current 2% capital gains credit is eliminated under SB 399, which offsets the tax liability impact of the income deduction.



Determining Montana Tax Liability Before Credits

Once taxpayers have determined their Montana taxable income, they determine their Montana tax liability by multiplying their taxable income by the marginal tax rates that apply to their income. Under current law, Montana has seven income tax rates, with the highest marginal tax rate being 6.9%. Each tax rate and the income threshold associated with each rate for tax year 2020 is provided in the table below.

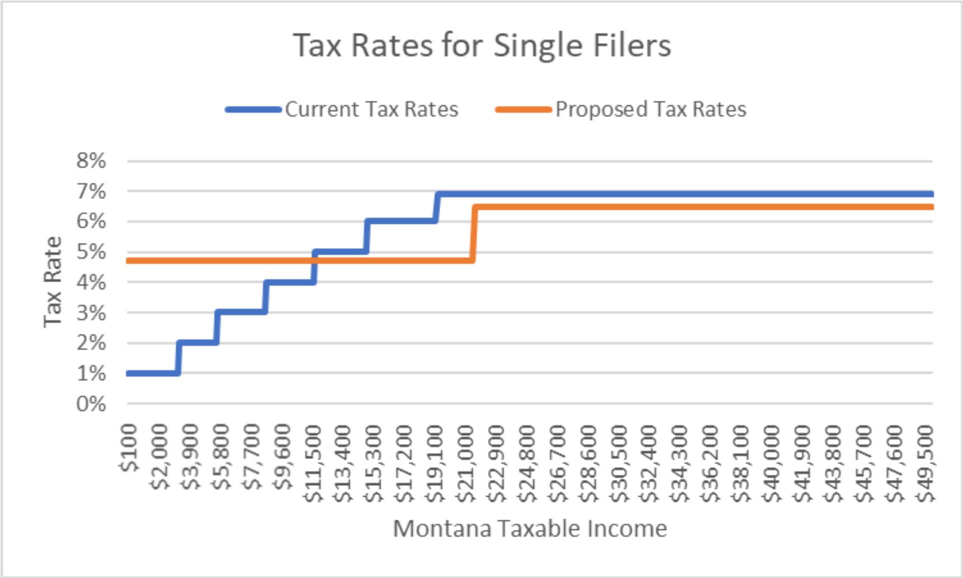
Tax Year 2020 Montana Taxable Income		
Above	Below	Tax Rate
$0	$3,100	1.0%
$3,100	$5,500	2.0%
$5,500	$8,400	3.0%
$8,400	$11,300	4.0%
$11,300	$14,500	5.0%
$14,500	$18,700	6.0%
$18,700		6.9%

Under current law, the income ranges for each of the tax rates is the same regardless of the taxpayer's filing status. However, Montana currently allows taxpayers who are married to file separate returns. This allows married taxpayers with income from more than one taxpayer to divide their income and a portion of the income earned by the second taxpayer is taxed at the lower marginal tax rates.

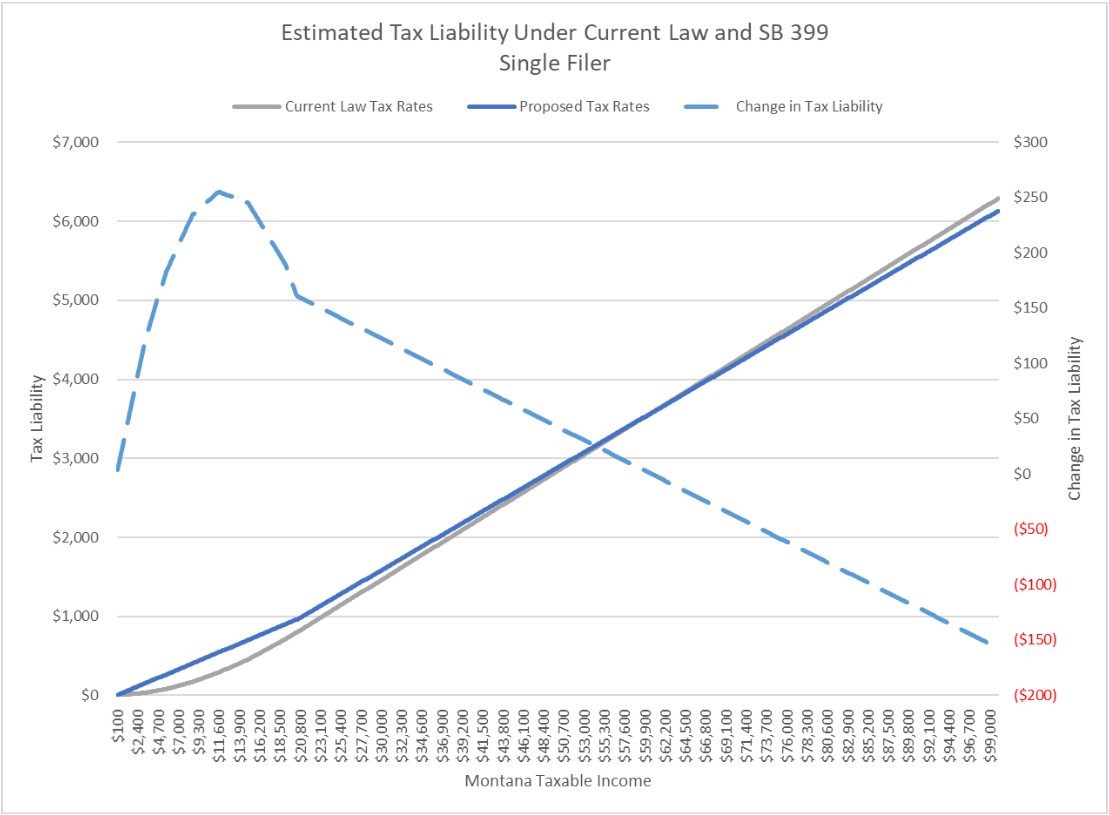
SB 399 changes the determination of a taxpayer's tax liability in several ways. First, the number of tax rates, and the income threshold for each tax rate, is changed. Under SB 399, the number of tax rates is reduced from seven to two. The two new tax rates are 4.7% and 6.5%.

The second change made by SB 399 is that the income threshold for the higher tax rate changes depending on the taxpayer's filing status. For single filers, the income threshold for the 6.5% is all taxable income above $20,500 in tax year 2022. For head of household filers, the 6.5% rate applies to all taxable income above $30,750. For married filers, the top rate threshold is $41,000 in tax year 2022. SB 399 does, however, eliminate the ability of married taxpayers to file separate Montana income tax returns if they filed a joint federal return.

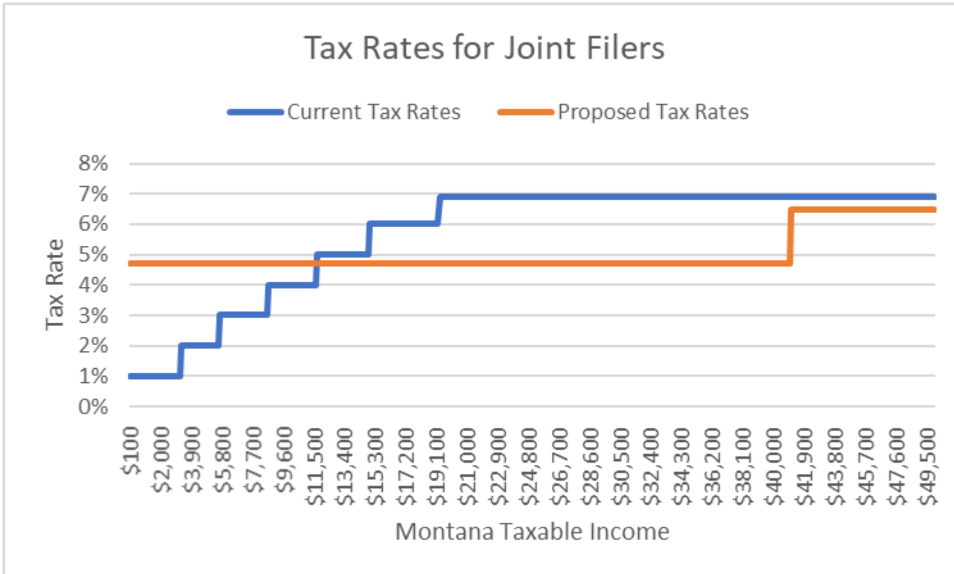
The table below shows the tax rates that would apply to the taxable income of a single filer in tax year 2022 under current law and SB 399 based on HJ 2 forecasts. Under current law, the tax rate applied to taxable income starts relatively low, at 1%, but gradually increases until it reaches 6.9% at $19,200. After this point, all income is taxed at the 6.9% rate. Under SB 399, all income below $20,500 is taxed at the same 4.7% rate. After $20,500, all income is taxed at the new top rate of 6.5%. As can be seen in the table below, all taxable income below $11,700 is taxed at a higher rate under SB 399, while all taxable income above $11,700 is taxed at a lower rate.

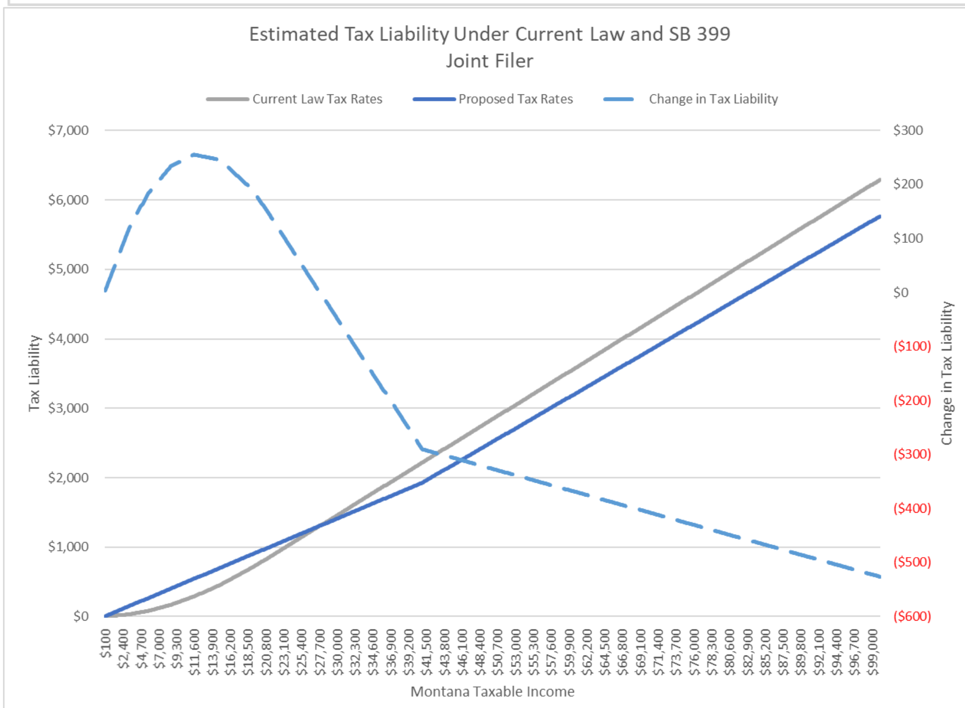


The higher tax rate under SB 399 for income below $11,700 means that taxpayers with relatively low taxable incomes will have a larger income tax liability under SB 399 than they would under current law. The table below shows the tax liability associated with a given taxable income for a single filer under current law and SB 399. As can be seen in the table, taxpayers with less than approximately $60,000 in MTI would have a larger income tax liability under SB 399 than they would under current law. However, after the $60,000 threshold, households would have a lower income tax liability under SB 399 than they would under current law. This shift is due to the higher initial tax rate, but lower top tax rate.



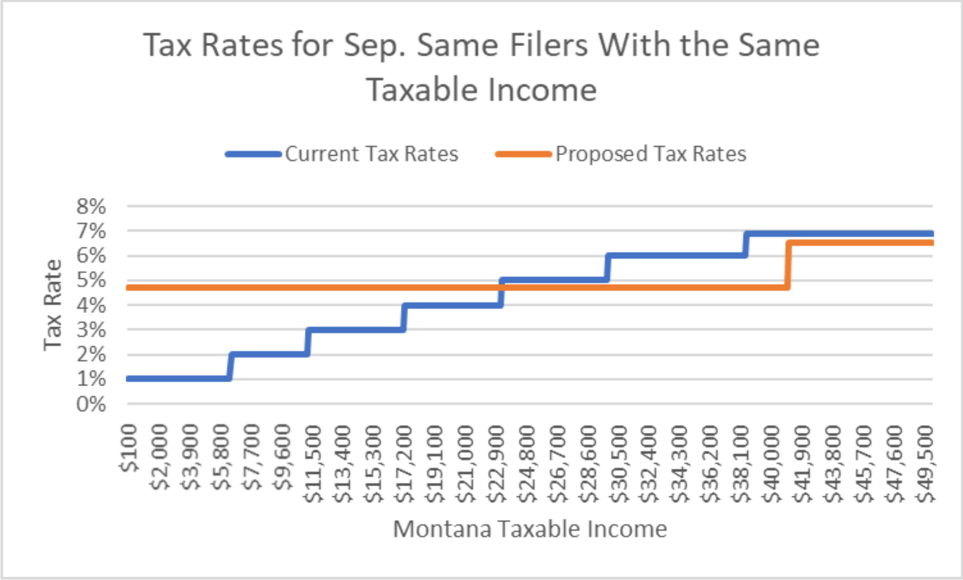
A similar pattern holds for taxpayers who file a joint return. The higher initial tax rate results in higher tax liabilities for taxpayers with lower taxable income amounts. However, the creation of a higher income threshold for joint returns means taxpayers need a lower taxable income before they have their tax liability reduced under SB 399. The tables below are the same tables for joint returns.

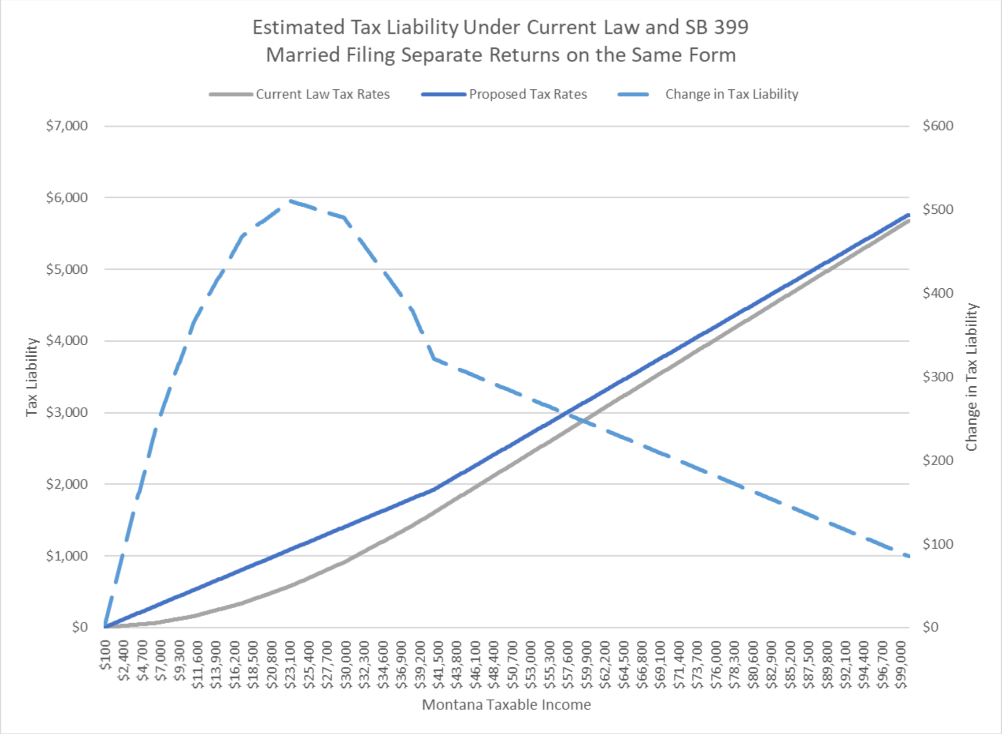




For married taxpayers who file separately on the same form, the impacts of the proposed changes are less clear. When filing separate returns, the income of each taxpayer is taxed at rates based on each taxpayer's taxable income. This means that taxpayers with income from each taxpayer will have the first $6,400 in taxable income taxed at 1% under current law in tax year 2022. It is not until each taxpayer reaches the top rate income threshold that income is all additional income is taxed at the state's top rate of 6.9%. Assuming each taxpayer reports the same amount of income, a married couple that file separately on the same form could have up to $38,400 ($19,200 x 2) in taxable income before the state's top tax rate applies to their income.

The table below has the tax rates applied to the taxable income of the married household that file separate returns on the same form. As can be seen in the table below, the ability to separate each taxpayer's taxable income increases the taxable income range before taxpayers are subject to the state's current top tax rate. With the lower tax rates being applied to a larger income range, the higher initial tax rate under SB 399 increases the initial tax rate applied to these households. It also increases the range of taxable incomes before taxpayers have their tax liability decrease under SB 399 relative to current law. For taxpayers who file separately on the same form, their tax liability would not begin to decrease under SB 399 until their taxable incomes exceeded approximately $121,000 in tax year 2022.





MONTANA Department of REVENUE

Montana Tax Due After Credits

Under current law, taxpayers are able reduce their tax liability by claiming one of Montana's 26 non-refundable income tax credits, or one of the state's four refundable tax credits. SB 399 eliminates 19 of Montana's income tax credits, with the largest being the state's 2% capital gains income tax credit. In tax year 2019, 91,000 full-year resident returns claimed nearly $51 million in capital gains credits. Of the remaining 18 credits, HJ 2 forecasts estimate that approximately $6 million in credits will be claimed each tax year. A table with the credits eliminated in SB 399, except for the capital gains credit, is included in the table below.

Forecasted Credit Amounts (Millions)				
	Tax Year			
Credits Eliminated	2022	2023	2024	2025
College Contribution Credit	$0.333	$0.342	$0.351	$0.360
Energy Conservation Credit	$3.919	$3.919	$3.919	$3.919
Alternative Fuel Credit	$0.014	$0.014	$0.014	$0.014
Health Insurance for Uninsured MT Credit	$0.075	$0.075	$0.075	$0.075
Elderly Care Credit	$0.083	$0.086	$0.088	$0.090
Dependent Care Credit	$0.025	$0.025	$0.025	$0.025
Recycle Credit	$0.554	$0.554	$0.554	$0.554
Biodiesel Blending and Storage Credit	$0.000	$0.000	$0.000	$0.000
Geothermal Systems Credit	$0.108	$0.108	$0.108	$0.108
Alternative Energy Credit	$0.408	$0.408	$0.408	$0.408
Low-emission wood or biomass credit	$0.194	$0.194	$0.194	$0.194
Alternative Energy Production Credit	$0.064	$0.064	$0.064	$0.064
Mineral / Coal Exploration Credit	$0.001	$0.001	$0.001	$0.001
Emergency Lodging Credit	$0.000	$0.000	$0.000	$0.000
Empowerment Zone Credit	$0.000	$0.000	$0.000	$0.000
Adoption Credit	$0.182	$0.182	$0.182	$0.182
Oil Seed Credit	$0.000	$0.000	$0.000	$0.000
Historical Property Preservation Credit	$0.035	$0.035	$0.034	$0.034
Total	$5.995	$6.006	$6.017	$6.028

Estimated Impacts of Proposed Changes

Using the department's income tax model, tax year 2019 income tax returns, and the revenue assumptions used in HJ 2, tax liability amounts for tax year 2022 under current law were forecasted. Next, the tax liabilities of the same taxpayers were forecasted for tax year 2022 under the changes made by SB 399. The change in tax liability for taxpayers under current law and SB 399 were then compared to determine who would be impacted by the proposed changes, and what the impact would be.

The tables on the following pages have the estimated revenue impact of the proposed changes relative to current law, the average tax liability change by income decile and elderly status, and the number of households who are expected to have their tax liability decrease, increase or remain unchanged. Tax liabilities must change by at least $50 and the taxpayer's Montana after-tax income must change by at least 0.1% for a household to be considered for a tax liability increase or decrease. The tax liability estimates do not include the impacts of any tax credits other than the state's capital gains income tax credit.

The first table below provides a breakdown of the estimated distributional impacts associated with the MTI changes made by SB 399. As the changes to MTI include the 30% capital gains deduction, the estimates below also include the elimination of the 2% capital gains tax credit. Making the changes to Montana taxable incomes, but not changing tax rates, is estimated to increase the tax liability of full-year residents by $25.251 million in tax year 2022. The proposed changes are estimated to increase the average tax liability of residents by approximately $53. The largest decreases in tax liabilities under the proposed changes are to households in the fourth- and fifth-income deciles, with an average tax liability decrease of $222 and $248, respectively. At the same time, households in the tenth income decile would have the largest increase in their average tax, with an increase of $919. Overall, nearly 46% of taxpayers would have their tax liability decrease under the changes to taxable income, while 26.7% would have their tax liability increase.

SB 399 Changes to Taxable Incomes Impacts to Full-Year Resident Taxpayers

Winners and Losers

		0.1% and $50			Number	Number	Average
DECILE	Income Range	Losers	Even	Winners	Winners	Losers	Change
1	$0 to $7,616	0.02%	99.97%	0.01%	5	8	($3)
2	$7,617 to $15,585	0.02%	54.46%	45.53%	21,788	8	($59)
3	$15,586 to $24,031	1.49%	26.81%	71.70%	34,313	715	($152)
4	$24,032 to $32,831	6.73%	16.25%	77.02%	36,863	3,220	($222)
5	$32,832 to $43,230	10.97%	11.92%	77.12%	36,906	5,249	($248)
6	$43,231 to $57,515	18.63%	10.92%	70.45%	33,715	8,915	($214)
7	$57,516 to $76,216	33.20%	13.04%	53.76%	25,727	15,890	($75)
8	$76,217 to $101,918	50.68%	13.84%	35.49%	16,983	24,252	$146
9	$101,919 to $143,139	67.86%	13.24%	18.91%	9,049	32,475	$438
10	$143,140 and over	76.98%	15.55%	7.47%	3,576	36,842	$919
Average		26.66%	27.60%	45.74%	218,925	127,574	$53

Individual Income Tax Revenue Impact

	Modeled Change in Tax Liability Before Credits ($ million)	
Tax Year	Change From Current Law	
2022	$25.251	
2023	$24.893	
2024	$26.589	
2025	$26.776	

Elderly Winners and Losers

Criteria	Elderly Status	Losers	Even	Winners
0.1% and $50	Less than 65 Years Old	25.60%	24.59%	49.81%
	At Least 65 Years Old	28.80%	40.70%	30.50%

State Tax Liability in Tax Year 2022 ($ million)
$1,418.534

The table on the next page provides a breakdown of the estimated distributional impacts associated with the tax rate changes made by SB 399. The tax rate changes proposed by SB 399, with no changes to taxable incomes, are estimated to reduce income tax liabilites of full-year residents by $6.6 million in tax year 2022, with an average tax liability change of $13. The tax rate changes increase the tax liability of households in the lower income deciles, while decreasing the tax liability of households in the top three income deciles. Households in the third income decile report the largest average tax liability increase, at $186, while households in the top decile report the largest tax liability decrease of $719. Overall, 18.7% of taxpayers are estimated to have their tax liability decrease by the rate changes alone, while 49.15% are forcasted to have their tax liability increase.

SB 399 Tax Rate Changes to Taxable Incomes Impacts to Full-Year Resident Taxpayers

Winners and Losers

DECILE	Income Range	0.1% and $50 Losers	0.1% and $50 Even	0.1% and $50 Winners	Number Winners	Number Losers	Average Change
1	$0 to $7,616	10.24%	89.76%	0.00%	0	4,902	$11
2	$7,617 to $15,585	66.55%	33.45%	0.00%	0	31,850	$117
3	$15,586 to $24,031	82.30%	17.69%	0.00%	1	39,389	$186
4	$24,032 to $32,831	88.86%	11.15%	0.00%	0	42,525	$176
5	$32,832 to $43,230	88.46%	11.46%	0.08%	38	42,337	$142
6	$43,231 to $57,515	70.04%	16.35%	13.61%	6,515	33,518	$84
7	$57,516 to $76,216	32.00%	40.45%	27.55%	13,186	15,313	$17
8	$76,217 to $101,918	33.70%	32.53%	33.76%	16,158	16,130	($33)
9	$101,919 to $143,139	18.98%	37.02%	44.00%	21,058	9,085	($111)
10	$143,140 and over	0.40%	31.34%	68.27%	32,672	190	($719)
Average		49.15%	32.12%	18.73%	89,628	235,239	($13)

Individual Income Tax Revenue Impact

Tax Year	Modeled Change in Tax Liability Before Credits ($ million): Change From Current Law
2022	($6.608)
2023	($4.349)
2024	($8.128)
2025	($11.388)

Elderly Winners and Losers

Criteria	Elderly Status	Losers	Even	Winners
0.1% and $50	Less than 65 Years Old	53.65%	28.82%	17.53%
	At Least 65 Years Old	32.35%	45.97%	21.68%

State Tax Liability in Tax Year 2022 ($ million)

$1,386.675

The last table provides the combined impacts of the taxable income and tax rate changes for tax year 2022. The combined changes made by SB 399 to Montana's personal income tax are estimated to reduce the tax liability of full-year resident taxpayers by $32.250 million in tax year 2022. The average tax liability reduction in tax year 2022 is estimated to be $67. Taxpayers in the seventh- and tenth-income deciles report the largest decrease in their average tax liability, with a reduction of $132 and $126, respectively. Households in the ninth income decile are the only decile to report a combined increase in their average tax liability. Overall, 46.15% of households are estimated to have their tax liability decrease under the changes made by SB 399, while 21.7% are estimated to have their tax liability increase.

SB 399 Impacts to Full-Year Resident Taxpayers

Winners and Losers

DECILE	Income Range	0.1% and $50 Losers	0.1% and $50 Even	0.1% and $50 Winners	Number Winners	Number Losers	Average Change
1	$0 to $7,616	0.05%	99.94%	0.01%	5	25	($3)
2	$7,617 to $15,585	0.41%	55.04%	44.55%	21,321	197	($51)
3	$15,586 to $24,031	9.20%	48.68%	42.12%	20,156	4,404	($39)
4	$24,032 to $32,831	19.24%	27.33%	53.43%	25,570	9,209	($40)
5	$32,832 to $43,230	20.71%	14.32%	64.97%	31,091	9,913	($92)
6	$43,231 to $57,515	24.87%	10.67%	64.46%	30,851	11,903	($119)
7	$57,516 to $76,216	29.49%	11.64%	58.88%	28,177	14,111	($132)
8	$76,217 to $101,918	33.59%	14.04%	52.37%	25,064	16,076	($94)
9	$101,919 to $143,139	41.41%	17.06%	41.53%	19,877	19,818	$27
10	$143,140 and over	37.63%	23.17%	39.20%	18,762	18,009	($126)
Average		21.66%	32.19%	46.15%	220,874	103,665	($67)

Individual Income Tax Revenue Impact

Tax Year	Modeled Change in Tax Liability Before Credits ($ million): Change From Current Law
2022	($32.250)
2023	($31.894)
2024	($34.759)
2025	($38.812)

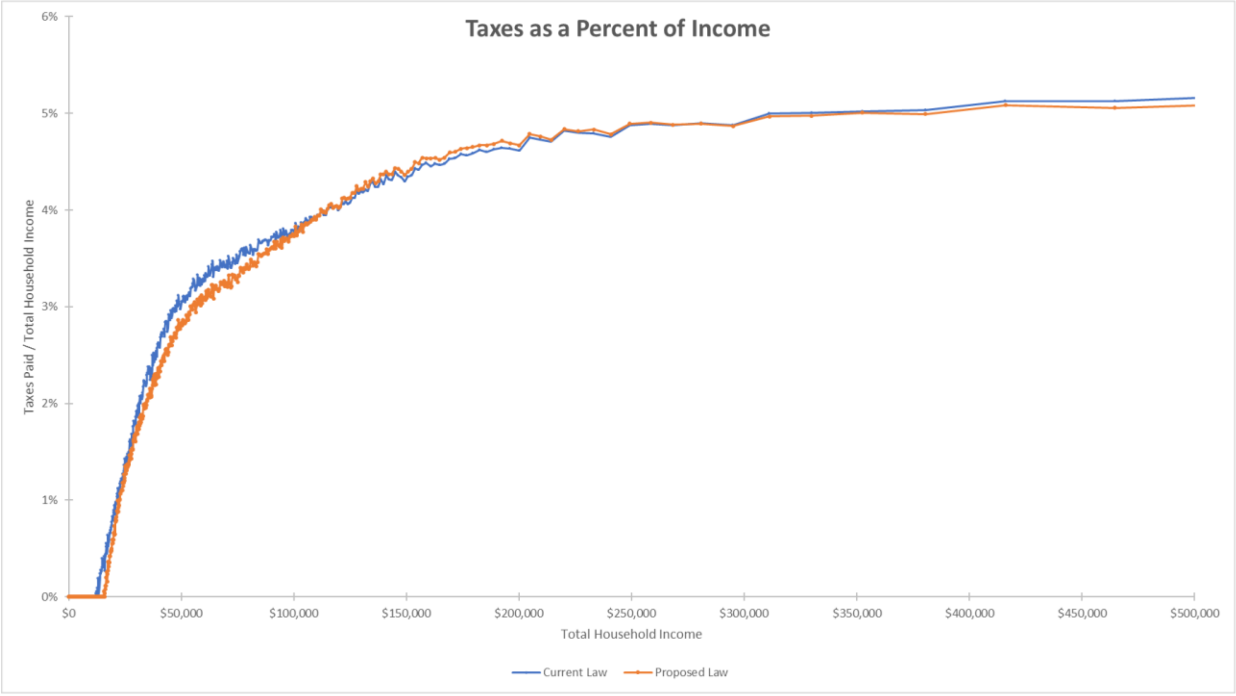
Elderly Winners and Losers

Criteria	Elderly Status	Losers	Even	Winners
0.1% and $50	Less than 65 Years Old	20.27%	30.66%	49.07%
	At Least 65 Years Old	25.14%	40.28%	34.58%

State Tax Liability in Tax Year 2022 ($ million)

$1,361.033

The graph on the following page provides a breakdown of the average effective tax rate for households who have a combined household income between $0 and $500,000. As can be seen in the graph, the average household with a household income between $13,000 and $100,000, or above $300,000, is expected to have their average tax liability decrease under the changes made by SB 399. At the same time, an average household with an income between $100,000 and $300,000 is expected to have their tax liability increase under the proposed bill.



If you have any additional questions, please don't hesitate to give me a call at (406) 444-4058.