Montana Department of Revenue

Mike Kadas
Director

Steve Bullock
Governor

Memorandum

To: Dan Villa, Budget Director State of Montana

From: Mike Kadas, Director Montana Department of Revenue

Date: December 4, 2017

Subject: Federal Tax Reform Impacts to the State's Budget

There are a number of proposed changes to federal corporate and individual income tax that would affect Montana, largely due to changes in federal taxable income. I have concerns that these changes will have a net impact that negatively impacts the state general fund. In addition, during the fog of the special session the Congressional Budget Office reported that the proposed tax cuts by the House would trigger sequestration and automatic elimination of a wide range of federal programs like mineral leasing payments to the state.

The following table outlines estimated revenue changes of the major provisions affecting corporate and individual income tax revenue and the elimination of the mineral leasing payments.

Estimated Impacts to the State General Fund

	TY 2018		TY 2019	
	In Millions			
Program	House Provisions	Senate Provisions	House Provisions	Senate Provisions
Individual/Pass-through Income Tax	30.9	(80.0)	31.4	(80.0)
Corporation Income Tax	(13.0)	(13.0)	(13.2)	(13.2)
Elimination of the ACA's Individual Mandate	0.0	(5.5)	0.0	(5.5)
Elimination of Federal Mineral Royalties[1]	(24.0)	(24.0)	(24.0)	(24.0)
Net State General Fund Impact	(6.1)	(122.5)	(5.8)	(122.7)

[1]Based on FY2018 payments

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To: Mike Kadas, Director

From: Dan Dodds, Senior Economist

Date: December 5, 2017

Subject: State Impact of Federal Tax Proposals

Tax reform, such as the Tax Reform act of 1986, generally pays for rate reductions through base broadening - eliminating deductions and exclusions that reduce the income subject to tax. When the federal government broadens its income tax base, states whose tax laws are tied to the federal law also have their tax bases broadened, and they can decide whether to spend the extra revenue, use it to reduce other taxes, or change their income tax laws to keep revenue unchanged.

The two bills under consideration in congress do not qualify as tax reform in this sense.

The House bill contains large rate reductions, but its base-broadening provisions make up only a small portion of the lost revenue.

The bill passed by the Senate cuts rates and *narrows* the tax base. The only significant base-broadening provision it includes is the elimination of deductions for state and local income and sales taxes, while it exempts part of the non-labor income of business owners from taxation.

The House bill would increase state income tax revenue by about $30 million per year, but would cause larger reductions in other state revenues. It increases income tax revenue primarily because of Montana's ties to federal law. When Congress eliminates deductions,that generally eliminates them for the state, which increases the state tax base.

The Senate bill would *reduce* state income tax revenue by about $80 million per year, because it reduces the state tax base.

Both bills give preferential treatment to non-labor income from pass-through businesses. The House bill does it through preferential rates, which has a small, indirect effect on Montana revenue through the deduction for federal taxes. The Senate bill does it by giving a deduction equal to 23% of qualifying income. Since Montana law allows all deductions allowed by federal law, this decreases Montana's income tax base.

If either of these bills becomes law, the state will have to reduce spending, increase other taxes, or amend its laws to prevent the revenue loss.

The attached table illustrates the state impacts due to federal tax reform on Montanans.

2018 Impacts of Senate Tax Bill

			Federal Income Tax Paid by Montanans					Montana Income Tax				
Percentiles	2016 Income Range	Number of Returns	Total Change ($ million)	Average Change	% with Tax Reduction at Least 2% and $50	% with Change Less than 2% or $50	% with Tax Increase at Least 2% and $50	Change ($ million)	Average Change	% with Tax Reduction at Least 2% and $50	% with Change Less than 2% or $50	% with Tax Increase at Least 2% and $50
	Less than $0	5,778	-$1.7	-$293.60	11.0%	89.0%	0.0%	$0.0	$0.00	0.0%	100.0%	0.0%
bottom 10%	$0 to $6,732	45,560	-$5.8	-$127.17	3.8%	96.2%	0.0%	$0.0	-$0.13	0.0%	100.0%	0.0%
10th to 20th	$6,733 to $13,279	45,561	-$13.8	-$301.90	22.5%	77.3%	0.1%	-$0.1	-$2.18	1.2%	98.8%	0.0%
20th - 30th	$13,280 to $20,190	45,561	-$22.6	-$496.51	62.0%	37.2%	0.8%	-$0.4	-$7.78	5.7%	94.3%	0.0%
30th - 40th	$20,191 to $27,612	45,561	-$30.3	-$664.05	69.2%	29.9%	0.8%	-$0.7	-$15.30	9.6%	90.4%	0.0%
40th - 50th	$27,613 to $36,458	45,561	-$38.1	-$836.00	79.9%	19.3%	0.8%	-$1.3	-$27.58	16.7%	83.3%	0.0%
50th - 60th	$36,459 to $48,398	45,560	-$46.8	-$1,026.41	92.8%	6.7%	0.4%	-$2.3	-$50.17	28.2%	71.8%	0.0%
60th - 70th	$48,399 to $64,070	45,561	-$58.3	-$1,279.03	94.8%	5.0%	0.2%	-$3.5	-$75.76	37.2%	62.8%	0.0%
70th - 80th	$64,071 to $85,153	45,561	-$76.1	-$1,669.94	96.4%	3.5%	0.1%	-$4.4	-$95.81	39.3%	60.7%	0.0%
80th - 90th	$85,154 to $119,200	45,561	-$98.7	-$2,166.46	97.2%	2.7%	0.1%	-$7.0	-$154.10	46.5%	53.5%	0.0%
90th - 95th	$119,201 to $160,158	22,490	-$62.0	-$2,755.39	89.9%	10.1%	0.0%	-$6.8	-$301.22	59.0%	41.0%	0.0%
95th-99th	$160,159 to $371,090	18,456	-$161.0	-$8,721.04	97.8%	2.2%	0.0%	-$16.8	-$912.20	71.0%	29.0%	0.0%
top 1%	$371,091 and over	4,614	-$132.3	-$28,682.57	83.3%	16.7%	0.0%	-$28.6	-$6,193.96	81.9%	18.1%	0.0%
	Total	461,385	-$747.3	-$1,619.70				-$71.7	-$155.44			

Montana Department of REVENUE

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Mike Kadas
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Steve Bullock
Governor

Memorandum

To: Director Kadas

From: Rose Bender, Economist RB

Date: December 4, 2017

Subject: Federal Tax Reform Corporate Estimate

There are a number of proposed changes to federal corporate income tax that would affect Montana, largely due to changes in federal taxable income. To estimate the impact to Montana's corporate income tax revenue, where available, the estimated revenue effects of the "Tax Cuts and Jobs Act", as ordered reported by the Committee on Finance on November 16, 2017, from the Joint Committee on Taxation (JCT) were used. These estimates were scaled down to Montana proportions. The estimate for increased expensing or 100 percent bonus depreciation relies on the department's estimate for bonus depreciation revenue loss in 2015 and, based on corporate income tax filings at that time, and current knowledge of corporate income tax filings.

The following table outlines estimated revenue changes of the major provisions affecting corporate income tax revenue by tax year. Please note that corporate income tax revenues experience great volatility, and specific information on how these proposals would be implemented in relation to federal taxable income is needed for a more accurate estimate.

This proposed legislation has been amended multiple times, and likely these amendments will continue. Current amendments have been reviewed and significant changes to the following estimates are not expected from estimates in the upcoming biennium, as reported in the following table.

Following the table is a more detailed description of the proposals.

Estimated Changes in Montana Corporate Income Tax Revenues (millions)

Provision	TY 2018	TY 2019
Reduction of dividends received deduction	$0.0	$0.0
Increase expensing/bonus deprecitation	($18.0)	($16.6)
Expansion of section 179 expensing	($0.4)	($0.7)
Small business accounting method reform and simplification	($1.0)	($0.8)
Limit net interest deductions to 30% of adjusted taxable income, carryforward of denied deduction	$2.8	$4.5
Modification to treatment of certain farm property	($0.3)	($0.3)
Repeal like-kind exchanges except for real property	$0.1	$0.1
Applicable recovery period for real property	($0.0)	($0.1)
Repeal of deduction for income attributable to domestic production activities	($0.0)	$0.4
Limitation on deduction by employers on expenses with fringe benefits	$0.3	$0.4
Accounting method changes	$0.4	$0.5
Territorial system summary		
Deduction for dividends received by domestic corps from certain foreign corporations	($2.0)	($3.0)
Treatment of deferred foreign income upon transition to participation exemption system of taxation - "deemed repatriation"	$5.2	$2.5
Total General Fund Impact	($13.0)	($13.2)

Business Tax Reform

Full Depreciation and expansion of expensing – In the short-term this will be a loser for the state. Under current law the depreciation is spread over several years. The proposed change will allow full depreciation of the investment in the first year. The increased limits on expensing section 179 property would also negatively impact Montana corporate income tax revenues. (-)

Reduction of dividends received deduction – This proposal reduces the dividends received. This would increase the corporate income tax base and increase corporate income tax revenues in Montana. (+)

Small business accounting method reform and simplification – This proposal modifies accounting rules that would negatively impact Montana corporate income tax revenues. (-)

Interest – A disallowance of a deduction for net interest expense of 30% of the businesses' adjusted taxable income would increase Montana corporate income tax revenues. (+)

Like-kind exchange limited to real property – Repealing the deferral of gain from like-kind exchanges, except for real property would increase Montana corporate income tax revenue. (+)

International Tax Reform

Territorial Tax System – A territorial tax system is proposed where US companies would generally pay tax only on domestic income, not foreign-derived income. The proposed changes could result in less corporate income tax revenue Montana receives from corporations, but the effect depends on how the changes are implemented at the federal level, in reference to federal taxable income.

Repatriation of Foreign Income – US multinationals would include as taxable income the proportionate share of qualified untaxed income from their foreign subsidiaries in which they have 10% or more ownership. The effect from this repatriation would depend on where this income is on the federal form. If it is included in line 28, Montana would have an increase in corporate income tax revenue. If not, there would be no change.