

PROPOSED STUDY PLAN FOR AN INTERIM STUDY OF THE INDIVIDUAL INCOME TAX FILING STATUS OF MARRIED TAXPAYERS

Prepared for the Revenue and Transportation Interim Committee

by

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July 2009

INTRODUCTION AND BACKGROUND

The individual income tax was first imposed in Montana in 1933 (Ch. 181, L. 1933) in response to declining state revenue from the property tax.¹ The Legislature established four income tax brackets for all taxpayers ranging from a 1% marginal tax rate on the first \$1,000 of taxable income to a 4% marginal tax rate on taxable income in excess of \$6,000. The marginal tax rates and tax brackets remained constant until 1957. In that year, the top tax rate was increased to 5% of taxable income in excess of \$7,000 (Ch. 228, L. 1957). The top tax rate was again increased to 7% in 1959 (Ch. 265, L. 1959) and to 7.9% in 1965 (Ch. 281, L. 1965). During an extraordinary session in 1967, the top marginal tax rate was increased to 10% on taxable income in excess of \$25,000 and the number of tax brackets was increased from six to eight (Ch. 5, Ex. L. 1967). During an extraordinary session in 1969, the Legislature increased the top marginal tax rate to 11% on taxable income in excess of \$35,000 (Ch. 10, Ex. L. 1969).²

In 2003, the Legislature revised the income tax laws by reducing the number of tax brackets, lowering the top marginal tax rate, making adjustments to the standard deduction and various exemptions, and limiting the deduction of federal income taxes paid (Senate Bill No. 407, Ch. 544, L. 2003). The legislation also imposed a selective sales tax on lodging accommodations and rental vehicles and increased the taxes on cigarettes, tobacco products, and moist snuff. Tax rates range from 1% on the first \$2,300 of taxable income to 6.9% on taxable income in excess of \$13,900 (indexed for inflation). The new tax rates went into effect in tax year 2005.

Montana law permits married taxpayers to file separate returns on the same form. This option allows married taxpayers to have lower combined taxes by filing separately rather than jointly. In 1963, the Legislature provided an election for married taxpayers to file a joint return and revised the provisions for married taxpayers filing separate returns (Ch. 201, L. 1963). Previously, a married taxpayer could file a separate return if the taxpayer was not living with or supporting a spouse or family. In 1969, the Legislature revised the provisions related to filing status (under what is now 15-30-142, MCA) as follows:

(1) Every single individual and every married individual *not filing a joint return with his or her spouse and* having a gross income for the taxable year of six hundred dollars (\$600) or over . . .

¹The Legislature was authorized to impose a property tax levy on all taxable property within the state to balance the state budget. That authority was repealed in 1997 (Ch. 123, L. 1997).

²On November 4, 1980, Montana voters approved Initiative Measure No. 86 to index income taxes to inflation.

The legislation also prohibited married taxpayers who filed a joint return from filing separate returns after the time for filing the return of either has expired.

States that impose income taxes employ a variety of techniques in the treatment of married taxpayers. Some states double the bracket widths for joint filers (Alabama, Arizona, Connecticut, Hawaii, Idaho, Kansas, Louisiana, Maine, Nebraska, New York, Oregon), or increase, but don't double, all or some of the bracket widths (Georgia, Minnesota, New Mexico, North Carolina, North Dakota, Oklahoma, Rhode Island, Vermont, Wisconsin). California doubles all bracket widths except the \$1,000,000 bracket. Some other states do not adjust bracket widths for joint filers (Arkansas, Delaware, Iowa, Kentucky, Mississippi, Missouri, Montana, Ohio, South Carolina, Virginia, West Virginia, District of Columbia) but may allow married taxpayers to file separately to avoid the marriage penalty or allow joint filers to make an adjustment to reduce the tax after it is calculated.³ States with a single income tax rate (Colorado, Illinois, Indiana, Michigan, New Hampshire, Tennessee, Utah) do not need to make adjustments for the marriage penalty.

Allowing married taxpayers to file separately on the same form may increase the complexity of filing a return and may affect the fairness of the tax system. Taxpayers have to determine how to allocate deductions, and in some cases income, to minimize tax liability. Allocations would be based on, for example, the marginal tax rate of each taxpayer and phase-out provisions related to deductions (federal law may come into play here). Some taxpayers may be more adept than other taxpayers in making these allocations, or they may rely on a tax preparer. Thus, similarly situated households may end up with different tax liabilities. In addition, a one-earner household may have a different tax liability than a similarly situated two-earner household. Even if the tax liabilities are not much different, there may be the perception that the system is not entirely fair. Finally, federal tax law provisions related to the filing status of married taxpayers may affect the allocation of income or deductions for married taxpayers who file separately in Montana.

STUDY RESOLUTION

Senate Joint Resolution No. 37, introduced by Sen. Jeff Essmann, requests an interim study of the filing options for married taxpayers under the state's individual income tax law. On May 27, 2009, the Legislative Council assigned the study (ranked 12th of 17 interim studies) to the Revenue and Transportation Interim Committee.

The resolution directs the Committee to:

- review the rationale for allowing married taxpayers in Montana to file separately on the same form and review the legislative history related to how married taxpayers may choose to file individual income tax returns;
- evaluate the benefits and drawbacks of revising the method for filing individual income tax returns by married taxpayers, including an analysis of changes to tax rate schedules if

³Tax Foundation, "State Individual Income Tax Rates, 2009", (as of May 15, 2009), footnote (s). Retrieved from http://www.taxfoundation.org/files/state_individualincome_rates-20090519.pdf, June 8, 2009.

the existing method of filing were changed; and

- consider policy options related to the filing method used by married taxpayers.

OUTLINE OF STUDY ACTIVITIES

The primary elements of the study may include the following:

- Review legislative history related to allowing married taxpayers to file separately on the same return.
- Discuss how federal income tax law may affect the allocation of income, deductions, or other exclusions from income for married taxpayers who file separately in Montana.⁴
- Survey other states' income tax provisions related to filing status and tax brackets for married taxpayers.
- Evaluate whether there are significant disparities in tax liability of similarly situated taxpayers.
- Consider advantages and disadvantages of allowing married taxpayers to file separately, requiring married taxpayers to file using the same filing status as the federal tax return, or some other method for determining tax liability for married taxpayers.
- Develop options, if options are considered necessary, related to the filing status of married taxpayers. The options would take into account other changes to individual income tax laws that may be necessary⁵. The options should be evaluated using established criteria for good tax policy.

PROPOSED SCHEDULE

The following schedule is proposed for conducting the study:

1. July 2009 meeting -- discuss, refine, and adopt study plan.
2. September 2009 meeting:
 - a. overview of Montana individual income tax structure, including peculiarities associated with filing status;
 - b. review legislative history of allowing married taxpayers to file separately on the

⁴Federal income tax law provides the basis for Montana income tax law. Federal rules for married taxpayers filing jointly may affect allocations for married taxpayers filing separately. In 2007, Senate Bill No. 281 (Ch. 509, L. 2007) provided that married taxpayers who file separate Montana income tax returns may use federal determinations of adjusted gross income reported on federal joint returns in determining Montana adjusted gross income for certain income items.

⁵For example, if the option were to expand tax brackets for married taxpayers filing jointly, consideration should be given to adjusting the phase-out of the \$3,000 retirement exclusion under 15-30-111(2)(c).

- c. same return and review administrative rules;
 - c. evaluate effects of federal income tax law on filing status for married taxpayers under current Montana law; and
 - d. demonstration of preparation of tax return depending on filing status.
3. December 2009 meeting:
- a. survey of other states' provisions related to the filing status of married taxpayers;
 - b. panel discussion on advantages and disadvantages of allowing married taxpayers to file separately, requiring married taxpayers to file jointly, or developing some other method; and
 - c. evaluate whether there are inherent inequities under existing law related to similarly situated taxpayers.
4. February 2010 meeting:
- a. consider options to revise Montana's filing status for married taxpayers; and
 - b. request draft legislation to implement options, if considered appropriate.
5. April 2010 meeting:
- a. review draft legislation if requested;
 - b. evaluate the effects of draft legislation;
 - c. act on draft legislation, if any; and
 - d. finalize recommendations and review outline for final report.
6. July or September 2010 meeting--review final report of committee actions.

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