Memorandum to HJ 35 Subcommittee: Mitigating Regressivity in our Tax System

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To: HJ 35 Subcommittee
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In Montana, families living on low and moderate incomes pay a higher share of their income in state and local taxes than high-income households. However, Montana's overall state and local tax system is less regressive than most other states, due in part to the lack of a statewide sales tax. Families living on lower and middle incomes in Montana spend a larger portion of their incomes on goods and services, and as a result would pay a larger proportion of a sales tax than higher income families.

Many questions arise about how to mitigate the impact of a statewide sales tax on families in Montana. It is very difficult, but not impossible, to reduce harm on families. One of the only states to accomplish this is Minnesota, which has a statewide sales tax coupled with additional tax provisions. Nearly every other state with a sales tax has a regressive tax system.

It is important to note that Minnesota has a comprehensive approach to their tax structure. As this committee looks to an array of tax policies, this memorandum includes provisions that would help mitigate the regressivity of a sales tax in Montana. However, MBPC stresses that to obtain a system that would not disproportionally impact families on low incomes, it would need to be done holistically and not in pieces. Efforts to reduce the regressivity of a sales tax are often the first to be eliminated during tough budget cycles, so families would feel compounding impacts of budget cuts as well as higher tax liability. **As a result, MBPC continues to be concerned about actions that will further shift tax liability on low and moderate-income families in Montana.**

Minnesota's Tax System
Even with a statewide sales tax, Minnesota is among a small number of states where income inequality is reduced by state tax policy. The reasons for this include:

1) A limit on itemized deductions for high-income earners;
2) A graduated income tax with a top income tax bracket starting at over $269,000 in income for joint filers;
3) A tax structure that taxes capital gains income at the same rates as other income;
4) Refundable tax credits for working families and dependent care including the Working Family Credit (state EITC), Child and Dependent Care Credit, and property tax refunds for homeowners and renters; and
5) An estate tax on estates in excess of $3 million.[1]

Each of these are detailed below, as well as an additional model from Maine.

1. Limit on Itemized Deductions for High-Income Earners

In Minnesota, taxpayers can choose either a standard deduction or itemized deductions.[2] The standard deduction in Minnesota is $13,300 for married filing joint, $6,650 for married filing separate and single, and $9,750 for head of households.[3] If itemized deductions are less than the standard deduction, taxpayers are allowed the standard deduction. Minnesota imposes its own limitations on itemized deductions for higher income filers at the following levels, adjusted annually for inflation.

- $186,350 in income for married couples filing joint returns,

- $93,175 in income for married separate filers, and
- $186,350 in income for single filers and head of households.

Taxpayers with incomes above the thresholds are required to subtract from state itemized deductions, the lesser of:

- 3% of income over the threshold, or
- 80% of total itemized deductions, excluding deductions for medical expenses, investment interest, casualty and theft losses, and gambling losses to the extent offset by gambling gains.

In comparison, Montana taxpayers are also able to choose a standard or itemized deduction. The standard deduction in Montana is set at 20 percent of Montana adjusted gross income with maximums and minimums. The maximum standard deduction in Montana is $4,580 for single and married filing separately and $9,160 for married filing jointly and head of household.[4] Montana does not limit the total amount of itemized deductions for high income filers.

Limiting itemized deductions for Montanans earning upwards of $250,000 for joint filers ($125,000 for single filers) would raise $30 million in annual state revenue.

2. Graduated Income Tax

Minnesota's income tax brackets[5]

Rate	Married Joint	Single	Head of Household
5.35%	$0 to $38,770	$0 to $26,520	$0 to $32,650
6.80%	$38,771 to $154,020	$26,521 to $87,110	$32,651 to $131,190
7.85%	$154,021 to $269,010	$87,111 to $161,720	$131,191 to $214,980
9.85%	Over $269,010	Over $161,720	Over $214,980

In comparison, Montana's income tax brackets set a top income tax bracket at only $17,900.[6]

Rate	Income
1%	$0 to $3,000
2%	$3,001 to $5,200
3%	$5,201 to $8,000
4%	$8,001 to $10,800
5%	$10,801 to $13,900
6%	$13,901 to $17,900
6.9%	Over $17,900

Adding a top personal income tax bracket in Montana at 8.9 percent of incomes in excess of $500,000 would raise $48 million in annual state revenue.

3. Capital Gains Taxation

Minnesota includes all net capital gains income in taxable income and taxes it at the same tax rates as other income.[7] Montana is one of only 9 states that offers this tax break for the state's wealthiest households. Montana offers a 2 percent tax credit on capital gains income, reducing the effective tax rate on capital gains income, or income made from investments.

Eliminating the capital gains tax credit would raise $49 million in annual state revenue and tax households earning income from investments at the same rate as households earning income from wages.

4. Minnesota's Refundable Tax Credits

Working Family Credit

Minnesota's working family credit is a refundable credit for individuals whose income is below a certain level. Eligible taxpayers must be eligible for the federal Earned Income Tax Credit (EITC). The tax credit is worth the following amounts, with phase-outs for higher qualifying incomes.

- For individuals with no qualifying children, 3.9 percent of the first $7,150 of earned income,
- For individuals with 1 qualifying child, 9.35 percent of the first $11,950 of earned income,
- For individuals with 2 qualifying children, 11 percent of the first $19,600 of earned income, and
- For individuals with 3 or more qualifying children, 12.5 percent of the first $20,000 of earned income.[8]

For 2018 income tax returns, income must be less than indicated in the following table to qualify.[9]

Number of Qualifying Children	Married Filing Joint	Any Other Filing Status
0	$21,000	$15,300
1	$46,000	$40,300
2 or more	$51,500	$45,800

Minnesota's working family tax credit maxes out at $2,500 per family.[10] In comparison, Montana's EITC, set at 3 percent of the federal credit, maxes out at $193 per family.

Increasing Montana's EITC (which is currently set at 3 percent of the federal EITC) to 20 percent of the federal credit would max out at $1,332 per family and cost the state $25.9 million annually.

Child and Dependent Care Credit

Minnesota's child and dependent care credit helps offset care expenses for qualifying dependents.[11] The Minnesota credit is equal to the federal child and dependent care credit amount ($3,000 for one dependent, $6,000 for two or more).[12] The credit begins phasing out at $50,990 adjusted gross income and fully phases out at $62,990 for one qualifying dependent and $74,990 for two or more qualifying dependents.

In comparison, Montana has no child and dependent care credit, but does allow a deduction for up to $4,800 of the expenses of maintaining a household or providing care for certain dependents while a taxpayer is at work or seeking employment. Married filing separately taxpayers must have income less than $22,800 to qualify.[13]

Property tax refunds for homeowners and renters

Homestead Credit Refund

The homestead credit refund provides tax relief to homeowners whose property taxes are high relative to their incomes.[14] The maximum refund in 2019 is $2,770. Homeowners whose income exceeds $113,150 are not eligible for refunds.

Renter's Property Tax Refund

Minnesota's renter's property tax refund program provides tax relief to renters whose rent and implied property taxes are high relative to incomes.[15] Implied property taxes are equal to 17 percent of rent paid. The maximum refund in 2019 is $2,150. Renters whose income exceeds $61,320 are not eligible for refunds.

In comparison, Montana has an elderly homeowner renter credit which is only for people over 62 with household incomes less than $45,000.[16] A property tax circuit breaker would provide property tax relief for Montana homeowners and renters whose property taxes are high relative to their incomes.

5. Sales Tax Fairness Credit

Another option for Montana to mitigate the effect of a sales tax is a sales tax fairness credit. Maine has the most progressive state sales tax fairness credit which ranges from $125 to $225 each year, depending on income levels and number of dependents.[17] The credit phases out beginning at $20,000 for single filers up to $40,000 for joint filers.

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[1] Minnesota Department of Revenue, Minnesota Tax Handbook, 2018 edition, Jan., 2018.
[2] Minnesota Legislature, Itemized and Standard Deductions in the U.S. and Minnesota Income Tax, accessed Oct., 4, 2019.
[3] Minnesota Department of Revenue, Minnesota income tax brackets, standard deduction and personal exemption amounts for 2019, Dec., 12, 2018.
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[6] Montana Department of Revenue, Individual Income Tax Tables, accessed Oct., 4, 2019.
[7] Williams, S. and Kleman, C., Capital Gains Taxation, Minnesota House Research, Mar. 2019.
[8] Minnesota Legislature, 2019 Minnesota Statutes, 290.0671, accessed Oct., 7, 2019.
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[11] Minnesota Department of Revenue, Child and Dependent Care Credit, accessed Oct., 7, 2019.
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[13] Montana Department of Revenue, Biennial Report July 1, 2016 – June 30, 2018, Dec., 2018.
[14] Williams, Sean and Swanson, Jared, Homestead Credit Refund Program, Minnesota House Research, Mar., 2019.
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[16] Montana Department of Revenue, Biennial Report July 1, 2016 – June 30, 2018, Dec., 2018.
[17] Maine Legislature, Maine Revised Statutes, 36-8-822, accessed Aug. 12, 2020.