

MINUTES OF THE MEETING
REVENUE ESTIMATING SUBCOMMITTEE OF THE TAXATION COMMITTEE
50TH LEGISLATIVE SESSION
HOUSE OF REPRESENTATIVES

February 5, 1987

The meeting of the Revenue Estimating Subcommittee was called to order by Chairman Harp on February 5, 1987, at 11 a.m. in Room 312B of the State Capitol.

ROLL CALL: All members were present with the exception of Rep. Schye and Sens. Hirsch and Hager, who were absent. Also present were Dave Bohyer, Legislative Council, Terry Johnson, OBPP, and Judy Curtis Waldron, LFA.

DISPOSITION OF INSURANCE PREMIUM TAX: Sen. Lybeck made a motion that LFA estimates for payments to retirement funds be approved. The motion CARRIED unanimously. (Exhibit a)

Terry Johnson explained that insurance premium tax is due March 1, and that the State Auditor must estimate withholding to the retirement system, transferring that amount to the general fund. He said some bills introduced this session will have a positive effect on Insurance Premium Tax, but the OBPP is using current law for now.

Rep. Williams made a motion to approve 6.5% for FY87, 88, and 89 for growth rates in gross insurance taxes and fees. The motion CARRIED unanimously.

DISPOSITION OF INHERITANCE TAX: Terry Johnson stated the OBPP used a base level from FY86 and made deductions for four large estates, totalling \$700,000 to arrive at an adjusted base, and then applied a 3.3% growth factor. He said the growth rate is a little lower, but ties in with projections on inflation rates. (Exhibit b)

Rep. Williams made a motion to approve OBPP figures for Inheritance of \$480,000 for each year for FY87, 88, and 89. The motion CARRIED unanimously.

DISCUSSION OF OTHER REVENUE: Terry Johnson advised that the basic difference is the underlying growth rate.

Judy Curtis Waldron commented that OBPP estimates are closer for FY87. She stated that in 1985 legislation was passed to sunset vehicle fees for the district courts in 1988. Ms. Waldron said those fees are approximately \$2.2 million. She added that other large fees come from poker machines, liquor license, railroad commission tax (levied by the PSC), and investment licenses (which generate approximately 1.8-1.9 million annually).

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Rep. Sands made a motion to approve OBPP figures for all years for Other Revenue (Exhibit #1).

Terry Johnson stated the general growth rate between 1981 and 1986 is 5.5%, and that the OBPP lowered that rate to 3.24% which, he said, is probably conservative.

Sen. Neuman made a substitute motion to approve OBPP figures for FY87, \$15 million for FY88, and \$15.5 million for FY89. The motion CARRIED unanimously.

DOR PRESENTATION ON ESTIMATED WINDFALL: Dan Bucks, Deputy Director, DOR, referred to his report "Impact" of Federal Tax Reform to Montana and Montanans (Exhibit #2). He stated that on page 5, DOR estimates increased state revenue for FY's 87-89, as a result of federal tax reform. He advised he believes the estimates are still reasonable and that the REAC lowered these estimates by 10% for the coming biennium.

Mr. Bucks said he is projecting 19% more than previously estimated for income when federal tax reform is fully phased in, and added that he did not know what year that would be. He explained that 19% equals a CY basis of \$37.5 million.

Mr. Bucks explained that he arrived at capital gains information as stated on page 3 of the report. He stated he anticipates capital gains will be 30% higher in 1986, and that 1987 will be 15% lower than 1985. Mr. Bucks anticipated that 1988-1991 will be close to what the figure was prior to federal tax reform changes.

Sen. Neuman asked how much of capital gains is paper and how much is from other sources. Mr. Bucks replied he did not know, and said that data is very difficult and costly to acquire. He added that he believed good national data is not available.

Sen. Neuman asked if stockholders who sell if the market goes up to 3200, would still have to pay capital gains in 1987, thus affecting subcommittee estimates for that year. Mr. Bucks replied data would be necessary to compute that information and would still be very difficult to acquire.

Chairman Harp advised that Mr. Vasquez, Policy Economics, would speak before the Subcommittee between 11 a.m. and 12:30 p.m. and before the Joint House and Senate Taxation Committees between 8 a.m. and 10:30 a.m. on Monday, February

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9, 1987. He asked Dan Bucks to return to the Subcommittee meeting on Tuesday, February 10.

ADJOURNMENT: There being no further business before the Subcommittee, the meeting was adjourned at 12:50 p.m.

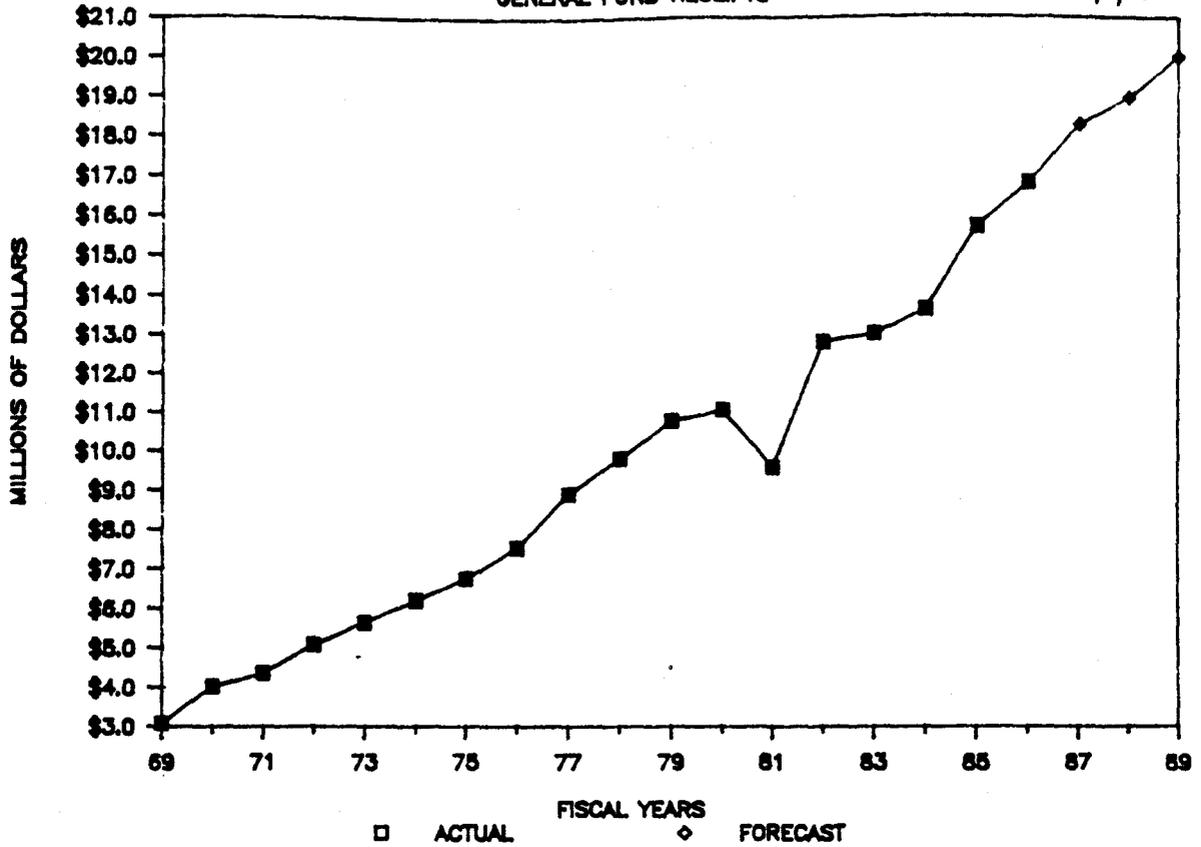

Representative John Harp,
Chairman

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INSURANCE PREMIUMS TAX GENERAL FUND RECEIPTS

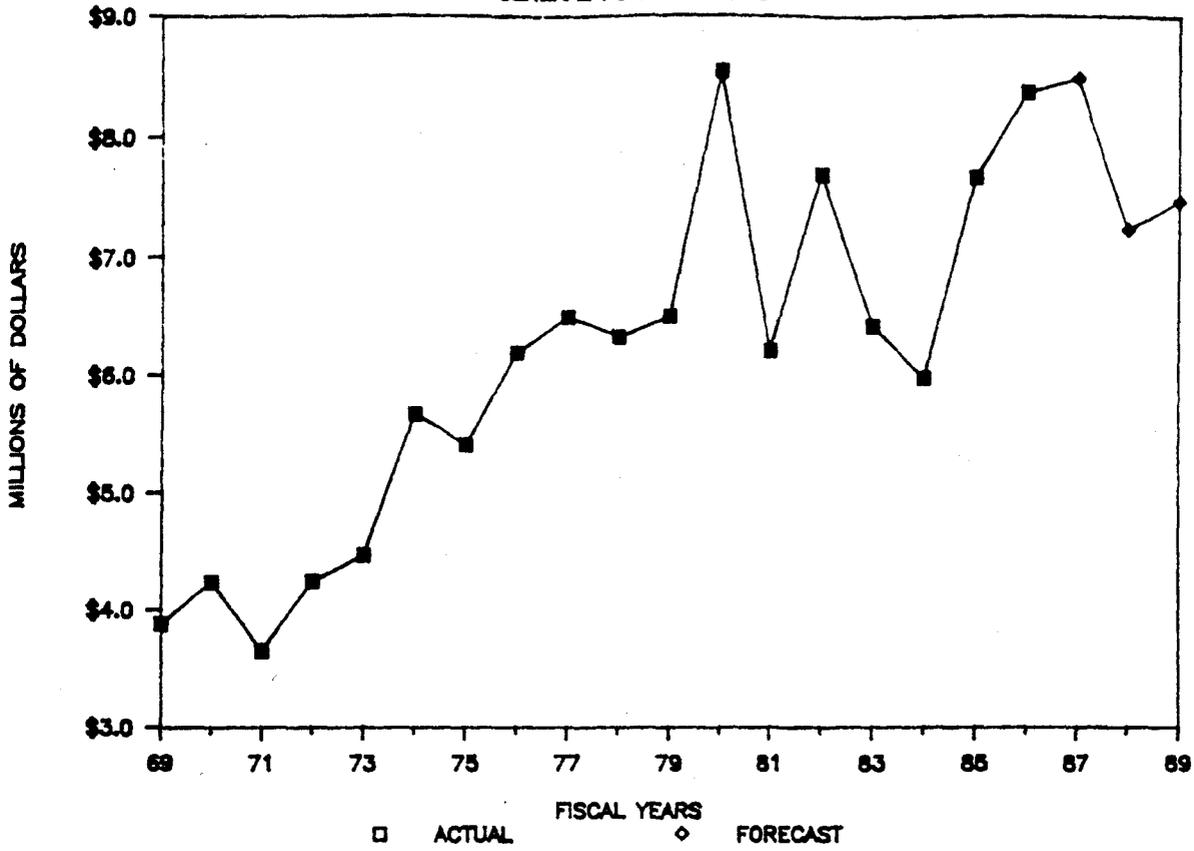


YR	GF RECEIPTS	PERCENT CHANGE
A 69	3.080786	
A 70	4.003699	29.96%
A 71	4.333425	8.24%
A 72	5.065751	16.90%
A 73	5.612473	10.79%
A 74	6.166923	9.88%
A 75	6.723217	9.02%
A 76	7.496699	11.50%
A 77	8.885923	18.53%
A 78	9.787436	10.15%
A 79	10.748226	9.82%
A 80	11.031794	2.64%
A 81	9.551061	-13.42%
A 82	12.790003	33.91%
A 83	13.011479	1.73%
A 84	13.621332	4.69%
A 85	15.691565	15.20%
A 86	16.780399	6.94%
F 87	18.247909	8.75%
F 88	18.937447	3.78%
F 89	20.002134	5.62%

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INHERITANCE TAX GENERAL FUND RECEIPTS



YR	GF RECEIPTS	PERCENT CHANGE
A 69	3.878692	
A 70	4.233429	9.15%
A 71	3.645252	-13.89%
A 72	4.233991	16.15%
A 73	4.457188	5.27%
A 74	5.659992	26.99%
A 75	5.395236	-4.68%
A 76	6.180106	14.55%
A 77	6.483191	4.90%
A 78	6.312432	-2.63%
A 79	6.490196	2.82%
A 80	8.537242	31.54%
A 81	6.195069	-27.43%
A 82	7.680529	23.98%
A 83	6.398489	-16.69%
A 84	5.960471	-6.85%
A 85	7.656622	28.46%
A 86	8.364764	9.25%
F 87	8.480448	1.38%
F 88	7.211403	-14.96%
F 89	7.449999	3.31%

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EXHIBIT #1
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OFFICE OF THE LEGISLATIVE FISCAL ANALYST
A Comparison of Revenue Forecasts and Assumptions

	FY1987	FY1988	FY1989
INSURANCE PREMIUMS TAX			
LFA	\$18,555,000	\$19,837,000	\$21,727,000
Executive	18,248,000	18,937,000	20,002,000
Difference	\$307,000	\$900,000	\$1,725,000
Growth Rate in Gross Insurance Taxes and Fees			
LFA	7.98%	6.59%	8.10%
Executive	6.66%	5.49%	5.49%
Payments to Retirement Funds			
LFA	\$5,446,000	\$5,637,000	\$5,911,000
Executive	5,361,000	5,671,000	6,005,000
Difference	\$85,000	(\$34,000)	(\$94,000)
Expenditures from Insurance Regulatory Account			
FY1987 Approp.	\$648,105		
Approp. Subcmte.		\$724,136	\$714,064
INHERITANCE TAX			
LFA	\$8,804,000	\$7,704,000	\$8,051,000
Executive	8,480,000	7,211,000	7,450,000
Difference	\$324,000	\$493,000	\$601,000
OTHER REVENUE			
LFA	\$21,931,000	\$16,037,000	\$16,880,000
Executive	21,433,000	14,630,000	15,014,000
Difference	\$498,000	\$1,407,000	\$1,866,000
Other Revenue w/o Vehicle Fees			
LFA	\$19,193,000	\$16,037,000	\$16,880,000
Executive	18,628,000	14,630,000	15,014,000
Difference	\$570,000	\$1,407,000	\$1,866,000

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THE IMPACT OF FEDERAL TAX REFORM ON MONTANA AND MONTANANS

An Introductory Presentation to the Committee on Taxation

Montana House of Representatives

by

**Dan Bucks, Deputy Director
Montana Department of Revenue**

January 8, 1987

This presentation summarizes the impact of federal tax reform on both Montana taxpayers and state revenues including:

- * The estimated change in individual income and corporate tax liabilities incurred by Montana taxpayers for both state and federal taxes in 1988.
- * The distribution of the change in individual income tax liabilities among taxpayers at different income levels, again for both state and federal taxes in 1988.
- * The estimated change in state revenues for Fiscal Years 87, 88, and 89 as a result of federal tax reform.

I will also discuss the procedures involved in making these estimates and some of the primary changes in federal tax law that cause the changes in tax liability.

This is an introductory presentation. I am certain that you will want additional information beyond what is provided here. We want to provide that information, and I would hope that the Department could return to discuss those items at future meetings of this committee.

The information presented here is a refinement of information presented on November 14 and December 13, 1986 to the Revenue Oversight Committee. I will be presenting today a new estimate of the change in federal taxes paid by Montana residents. This new estimate incorporates assumptions about the change in capital gains earned as a consequence of the changes in federal tax law. The old estimate is also presented for comparison.

This same assumption about changes in capital gains had already been worked into the estimates of state tax liability, so those estimates are not affected by this refinement.

Information Behind the Estimates

Three kinds of information are used to make the estimates presented here:

- 1) Income Information -- how much, what kinds, and how it is distributed among different categories of taxpayers.
- 2) Tax Law Information -- what changes in law and when.
- 3) Taxpayer Responses -- what taxpayers do in response to changes in laws to minimize their taxes.

For income, the Department used a database of approximately 45,000 returns for 1984. This database includes 10% of the returns with adjusted gross incomes below \$40,000 and 100% of the returns above that level. This database was reviewed for the Revenue Oversight Committee by two Montana economists, Myles Watt of MSU and Maxine Johnson of the U of M, and they certified the database as valid for estimating purposes.

In grouping taxpayers by income level, we use a broad measure of income that includes Montana adjusted gross income plus all income declared on returns that is excluded from taxation. The excluded items that are added to arrive at this income measure include: the excluded portion of capital gains, payments to retirement plans, the marriage deduction, excluded interest, exempt retirement income, and other exempt income reported on returns. We refer to this measure as "expanded income."

We use expanded income for two important reasons:

- 1) It is a better measure of ability to pay income taxes than other measures available to us, and
- 2) It does not change significantly as a result of changes in tax law. It is a constant measure against which changes in federal and state tax law can be evaluated. Thus, we avoid comparing apple and orange income.

The changes in tax law used in these estimates are primarily those changes in federal law that will be in effect during 1988. Although portions of the new federal tax law will be phased in through 1991, most provisions are effective in 1988. 1987 is a unique transition year during which fewer portions of federal tax reform will be effective than in later years. Except for the FY 88 estimate of state revenues, the tax law effective for 1987 is not used in these estimates.

Whenever I refer to the term "old law," I will be referring to existing state law and the federal law before tax reform. The term "current law" is used to refer to existing state law and the new federal tax law for 1988.

Taxpayers are expected to change the way they earn or spend their incomes because of the new federal law. Consumers are expected to borrow less in the future because of the phase-out of the consumer interest deduction. Investors are expected to shift from investments in stocks to investments in assets with fixed returns because of the increase in the effective tax rate on capital gains. Other investors are expected to shift out of tax shelters and into investments based on their real economic return.

Overall, these taxpayer responses are expected to be significant and must be anticipated in order to generate reasonably valid estimates.

Taxpayer responses, without exception, operate in one direction: they reduce the level of taxes that taxpayers would otherwise have paid.

For estimates of taxpayer responses, we have relied on the same people that Congress has relied on for their estimates: the Joint Committee on Taxation.

The most important assumption concerning taxpayer responses is the one involving capital gains. The capital gains assumption is critical for two reasons:

- 1) The repeal of the 60% exclusion of capital gains is one of the largest single changes in taxable income in the new federal law, and
- 2) The taxpayer response is expected to be among the strongest for the first few years that federal tax reform is effective.

The Joint Committee on Taxation's capital gains assumption is as follows:

For 1986, capital gains will be 30% higher than in 1985 because of the early sale of assets that would otherwise have been sold in 1987 or later years. For 1987, capital gains income will be 15% lower than in 1985. For 1988 through 1991, capital gains income will be on a recovery growth path that will bring total capital gains to a level in 1991 equal to what they would have been without any federal tax changes.

In summary, for the estimates presented we have used 1984 income data as a base. For "old tax law" estimates we use existing state law and the old federal tax law before reform. For "current law" estimates we use existing state law and the new federal law for 1988. Finally, we use the Joint Committee on Taxation's assumptions of taxpayer responses to the new federal law.

Statistics on Total Impact

On November 14, 1986, the Department presented to the Revenue Oversight Committee the following estimates of the effect of federal tax reform on Montana taxpayers:

IMPACT OF FEDERAL REFORM ON MONTANA TAXPAYERS
CY 1988 Tax Liabilities (Millions of Dollars)

	<u>STATE</u>	<u>FEDERAL</u>	<u>TOTAL</u>
Individuals	\$ 37.48	\$ (89.12)	\$ (51.64)
Corporations	<u>6.09</u>	<u>37.69</u>	<u>43.78</u>
Total	\$ 43.57	\$ (51.43)	\$ (7.86)

In these estimates, overall tax liabilities decline by almost \$8 million. Individuals see their combined taxes fall by nearly \$52 million, while combined corporate taxes increase by \$44 million.

We have recently revised the estimate for federal tax liabilities to incorporate the assumption about the response of taxpayers to the change in capital gains taxation -- the dominant taxpayer response anticipated in the next few years. That assumption was already incorporated in the state tax figure, so that estimate is not changed. The revised estimates are as follows:

REVISED IMPACT OF FEDERAL REFORM ON MONTANA TAXPAYERS
CY 1988 Tax Liabilities (Millions of Dollars)

	<u>STATE</u>	<u>FEDERAL</u>	<u>TOTAL</u>
Individuals	\$ 37.48	\$(110.31)	\$ (72.83)
Corporations	<u>6.09</u>	<u>37.69</u>	<u>43.78</u>
Total	\$ 43.57	\$ (72.62)	\$ (29.05)

With this change in the analysis, the total reduction in state and federal taxes is estimated at \$29 million. Combined corporate taxes are still estimated to increase by \$44 million, but combined state and federal taxes for Montana residents are expected to decline by \$73 million.

Some national experts believe that the taxpayer response to the new federal law will result in even lower levels of capital gains than assumed by the Joint Committee on Taxation. If assumptions advocated by other experts were used, the estimated state and federal taxes would be even lower than indicated above, meaning that the combined taxes for individuals would decrease more than

the nearly \$73 million listed above. The total decrease for all taxpayers would also be more than \$29 million.

The Department's estimates of increased state revenue because of federal tax reform are as follows:

IMPACT OF FEDERAL REFORM ON STATE REVENUES
(Millions of Dollars)

<u>Fiscal Year</u>	<u>Individuals</u>	<u>Corporations</u>	<u>Total</u>
1987	\$ 4.40	\$ 1.07	\$ 5.47
1988	22.58	4.72	27.30
1989	<u>39.83</u>	<u>6.21</u>	<u>46.04</u>
Total	\$ 66.81	\$ 12.00	\$ 78.81
89 Biennium Only	\$ 62.41	\$ 10.93	\$ 73.34

These are the estimates presented to the Revenue Oversight Committee on November 14, 1986. The Revenue Estimating Advisory Council reduced these estimates by 10% in its forecasts of future revenue.

Reasons for the Changes

Federal tax reform generally broadened the base of the corporation and individual income taxes by eliminating or reducing various credits, deductions, and exclusions. In exchange, both corporate and individual income tax rates were reduced. In addition, personal exemptions and standard deductions were increased significantly for individuals. For example, personal exemptions will double to \$2,000 per person in 1989.

Although estimated to be revenue neutral at the federal level, the federal tax reform law increases state taxes. This change occurs because Montana's tax law is tied to federal law for the base of its income and corporation taxes, but it is not tied at present to the federal personal exemptions and standard deductions. Nor is Montana tied to the federal rate structure. Because the income base expands, state taxes increase.

The opposite occurred, of course, in 1981 when changes in federal tax law reduced the base of the federal tax as well as Montana's tax base.

The changes in federal law that have the greatest impact on the state taxes paid by individuals are as follows:

- 1) Repeal of the 60% exclusion for capital gains,

- 2) Limitations on "passive" losses used to offset ordinary income,
- 3) Limitations on deductions for nonbusiness interest,
- 4) Repeal of the investment credit, and
- 5) Limitations on deductions for IRA's and Keogh retirement plans.

About one-half of the increase in state taxes for individuals is estimated to be attributable to the repeal of the capital gains exclusion alone. It is by far the most significant federal tax reform feature that will affect Montana.

The changes in federal law that have the greatest impact on the state taxes paid by corporations are as follows:

- 1) Capitalization of certain costs that are currently expensed,
- 2) Repeal of the investment credit, and
- 3) Recognition of gains on pledges of installment obligations.

For both individuals and corporations, state tax payments will be reduced slightly because of the liberalization of depreciation deductions for equipment.

Distribution of the Impact Among Individuals

Attached are tables and graphs that summarize the impact on individuals of federal tax reform.

Montana households are divided into ten income groups of nearly equal size. Approximately 28,880 households are represented in each income group.

The statistics represent averages for each group. Within each group, there are taxpayers who will experience either an increase or decrease in taxes and to varying degrees.

There are tables for both the first estimate ("Version I") the Department made of Calendar Year 1988 tax liabilities and the second estimate ("Version II") that is presented today for the first time. Graphs are attached for Version II. Graphs can also be made available for Version I if desired.

Although the statistics indicate a slight increase in taxes for the lowest income group, the majority of taxpayers at this level

will actually experience a decrease. The results indicated in the table for this group are attributable, in part, to the fact that the statistics are not adjusted for tax sheltering activities. Consequently, the income of some individuals is understated, and even though their actual income is much higher, they are included. Taxes will increase for individuals investing in tax shelters, and their increases outweigh the decrease in taxes that will occur for most persons in this income group.

Except for this lowest income group, the statistics indicate that the average taxpayer at every income level will see a reduction in combined income taxes.

CHANGE IN INCOME TAXES : OLD LAW TO CURRENT LAW

Total Number of Households	Income Group	Absolute Change			Percentage Change		
		Graph IA Federal Old Law to Current Law	Graph IB State Old Law to Current Law	Graph IC Total Old Law to Current Law	Graph ID Federal Old Law to Current Law	Graph IE State Old Law to Current Law	Graph IF Total Old Law to Current Law
28887	\$ 3,000	3.23	2.58	5.81	40.61%	27.31%	33.39%
28956	\$ 5,500	-49.07	0.45	-48.62	-76.29%	1.27%	-48.80%
28845	\$ 8,500	-117.99	3.02	-114.97	-43.67%	3.72%	-32.71%
28846	\$ 11,750	-183.12	8.93	-174.20	-31.48%	5.97%	-23.83%
28896	\$ 15,750	-223.84	25.77	-198.07	-22.57%	10.03%	-15.86%
28843	\$ 20,500	-280.11	46.41	-233.69	-18.11%	11.76%	-12.04%
28926	\$ 26,250	-373.17	79.32	-293.85	-16.69%	13.60%	-10.42%
28882	\$ 33,000	-475.81	124.70	-351.11	-15.24%	15.17%	-8.90%
28880	\$ 43,500	-771.44	199.13	-572.31	-17.41%	17.51%	-10.28%
28877	No limit	-615.81	807.70	191.89	-5.38%	33.04%	1.58%

Estimates of state tax changes include assumptions about taxpayer responses to new federal law.

Estimates of federal tax changes do not include assumptions about taxpayer responses.

CHANGE IN INCOME TAXES : OLD LAW TO CURRENT LAW

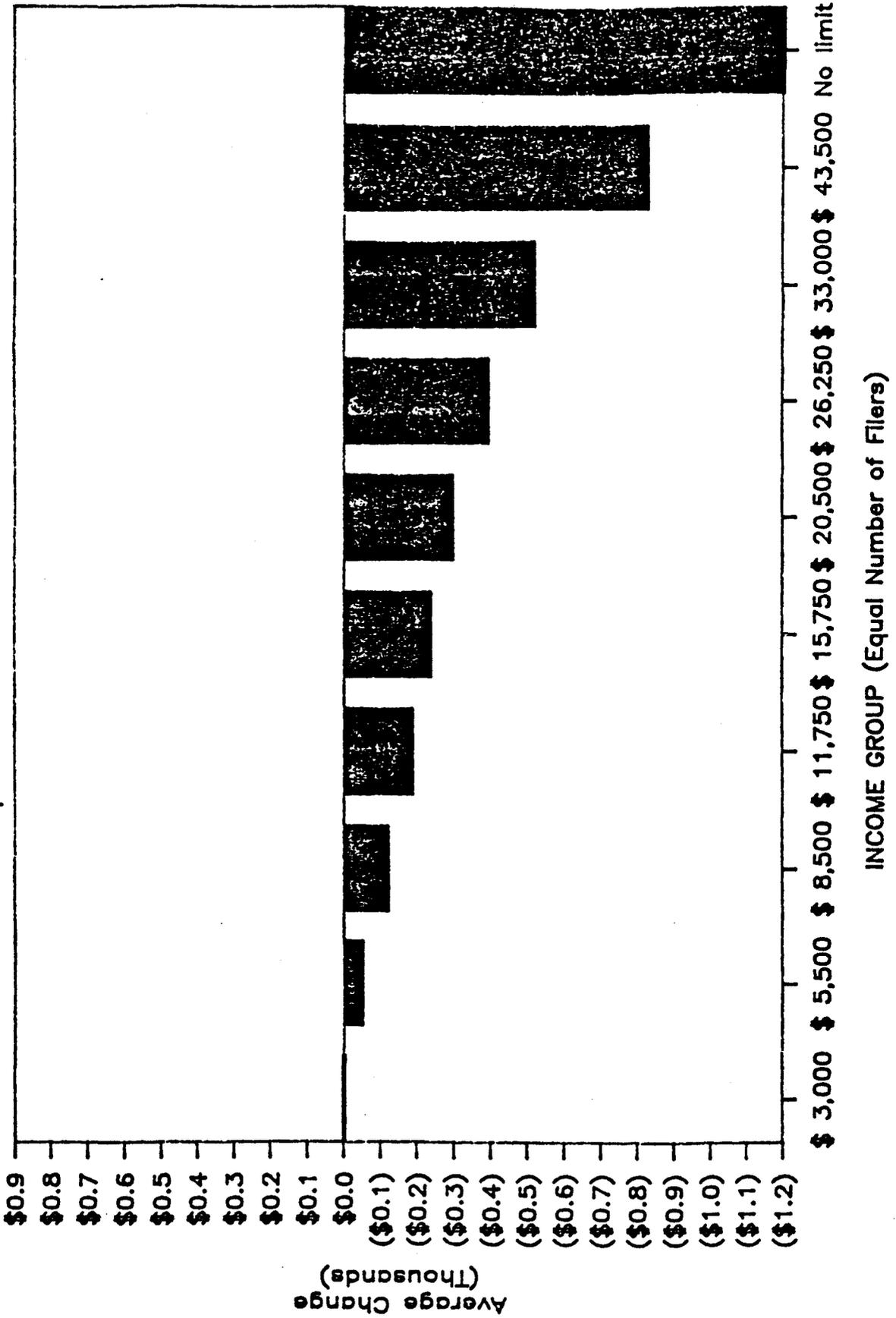
Total Number of Households	Income Group	Absolute Change				Percentage Change			
		Graph IIA Federal Old Law to Current Law	Graph IIB State Old Law to Current Law	Graph IIC Total Old Law to Current Law	Graph IID Federal Old Law to Current Law	Graph IIE State Old Law to Current Law	Graph IIF Total Old Law to Current Law		
28867	\$ 3,000	2.77	2.58	5.35	34.83%	27.31%	30.75%		
28956	\$ 5,500	-49.45	0.45	-49.00	-76.88%	1.27%	-49.18%		
28845	\$ 8,500	-120.02	3.02	-117.00	-44.42%	3.72%	-33.29%		
28846	\$ 11,750	-187.15	8.93	-178.23	-32.17%	5.97%	-24.38%		
28896	\$ 15,750	-235.94	25.77	-210.17	-23.79%	10.03%	-16.83%		
28843	\$ 20,500	-295.14	46.41	-248.72	-19.08%	11.76%	-12.81%		
28926	\$ 26,250	-351.31	79.32	-311.99	-17.50%	13.60%	-11.06%		
28862	\$ 33,000	-518.04	124.70	-393.34	-16.59%	15.17%	-9.97%		
28860	\$ 43,500	-826.73	199.13	-627.60	-18.66%	17.51%	-11.27%		
28877	No limit	-1199.73	807.70	-392.03	-10.47%	33.04%	-2.82%		

Estimates of state tax changes include assumptions about taxpayer responses to changes in federal tax law.

Estimates of federal tax changes include assumptions about taxpayer responses to federal tax law changes concerning capital gains.

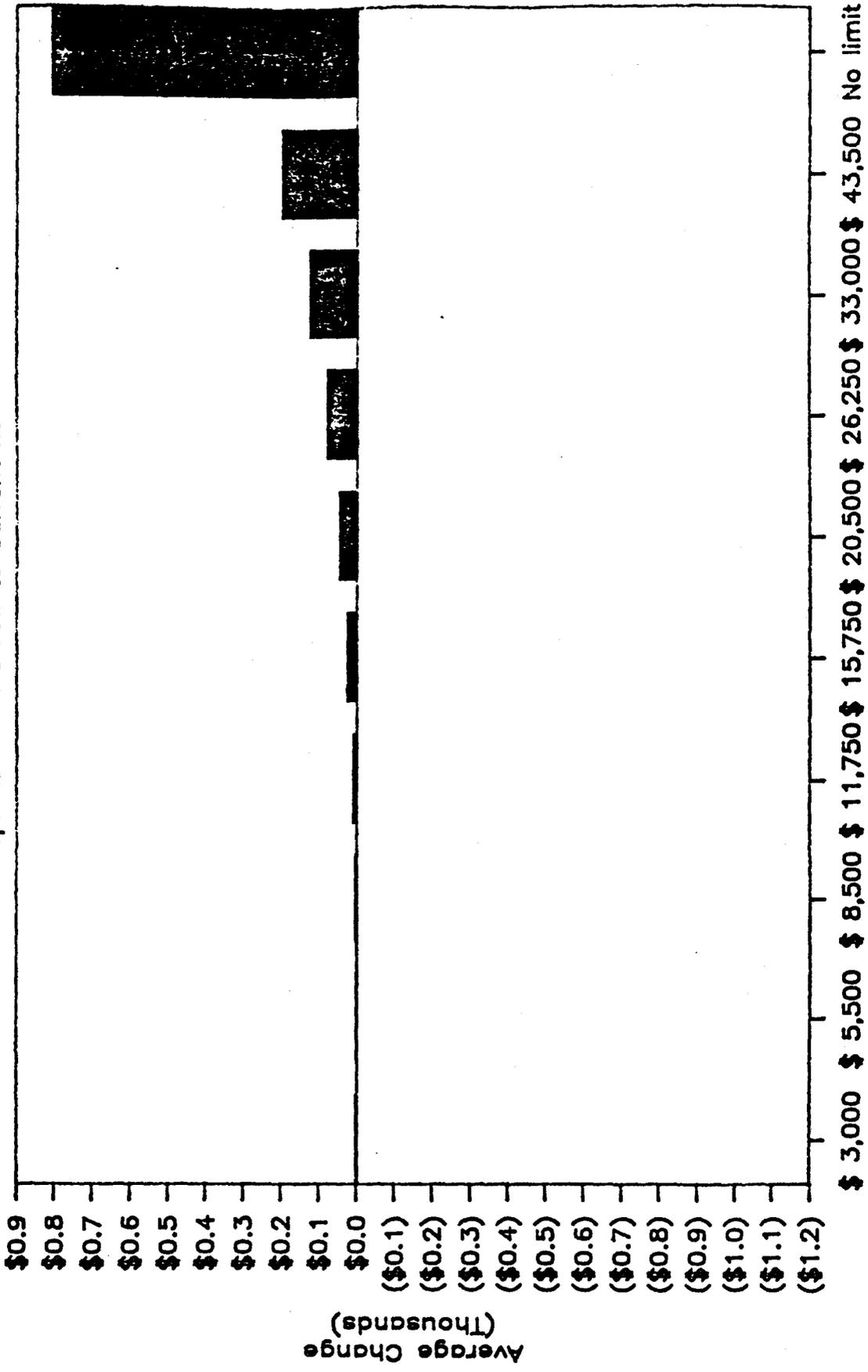
CHANGE IN FEDERAL INCOME TAXES

Graph IIA Old Law to Current Law



CHANGE IN STATE INCOME TAXES

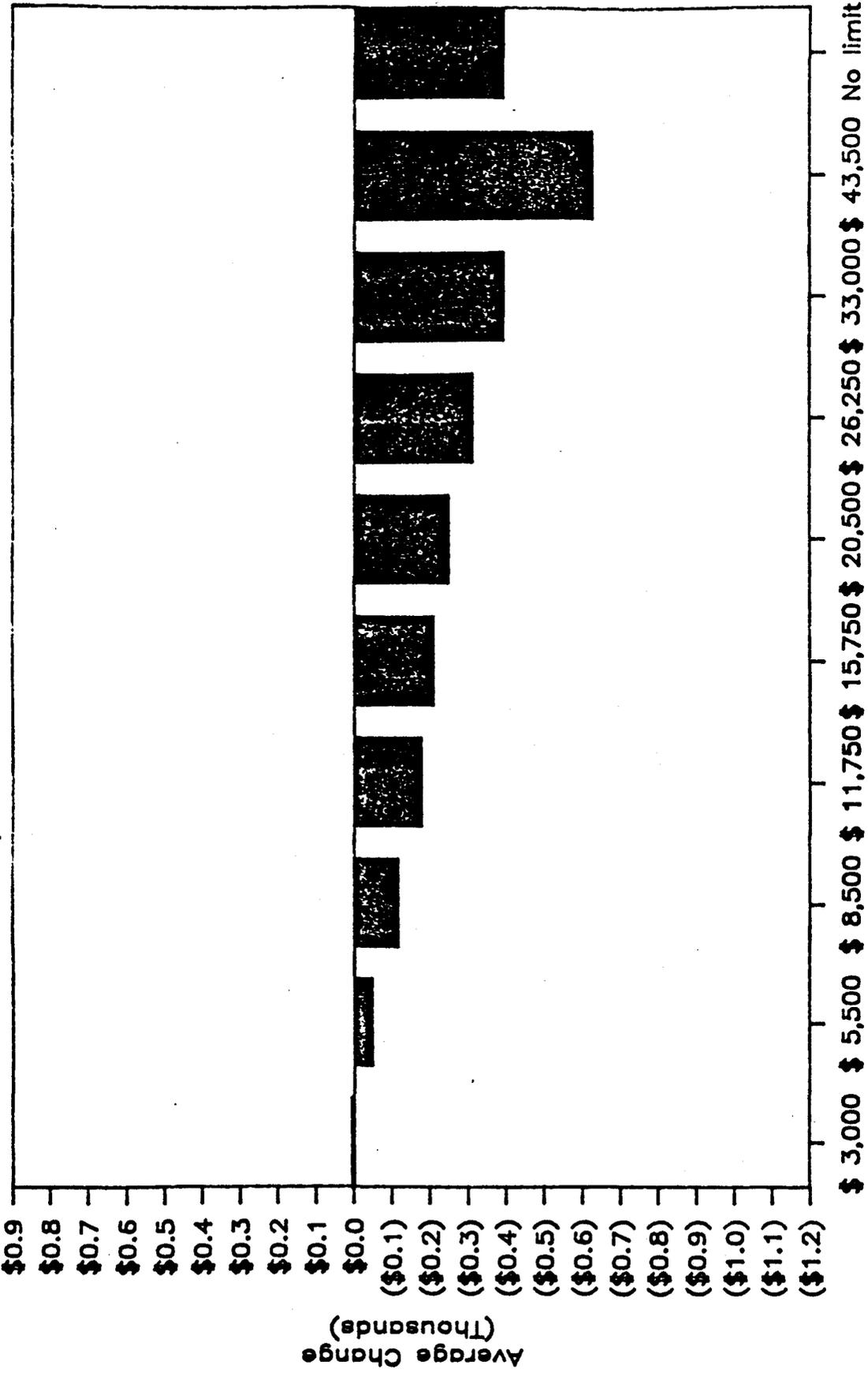
Graph IIB Old Law to Current Law



INCOME GROUP (Equal Number of Filers)

CHANGE IN TOTAL INCOME TAXES

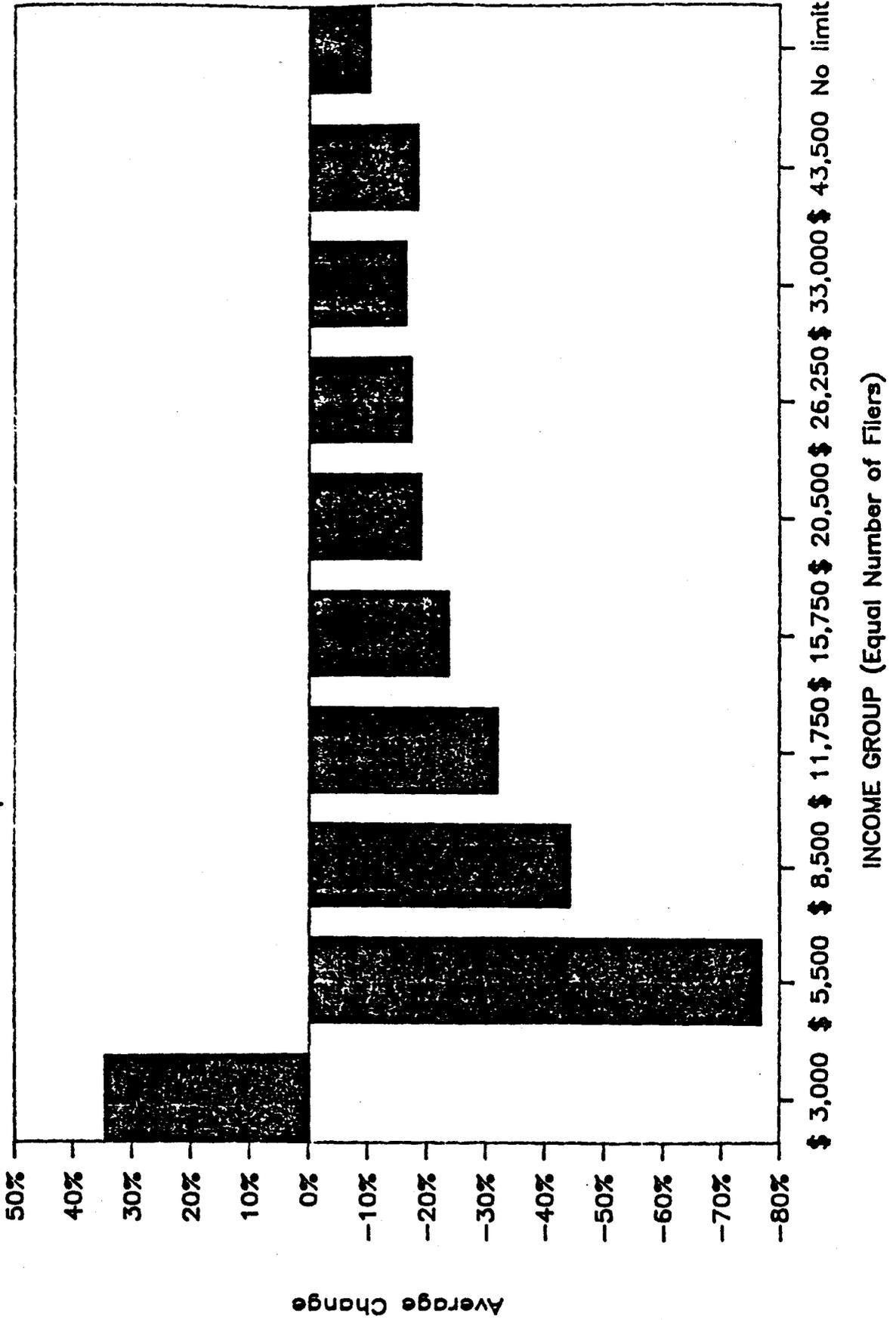
Graph IIC Old Law to Current Law



INCOME GROUP (Equal Number of Filers)

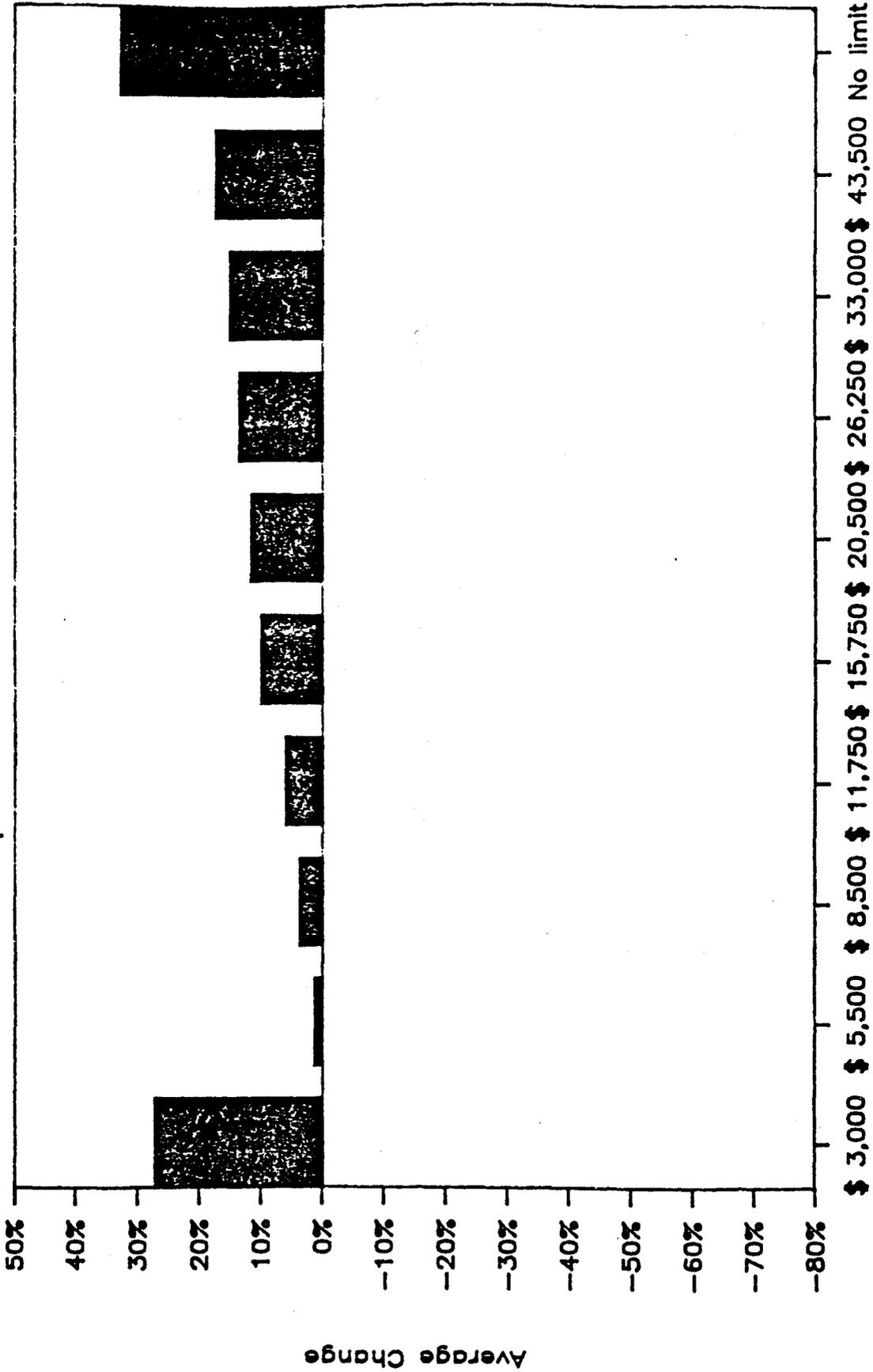
PERCENT CHANGE IN FEDERAL INCOME TAXES

Graph IID Old Law to Current Law



PERCENT CHANGE IN STATE INCOME TAXES

Graph IIE Old Law to Current Law



INCOME GROUP (Equal Number of Filers)

PERCENT CHANGE IN TOTAL INCOME TAXES

Graph III Old Law to Current Law

