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

January 8, 1987

The meeting of the Taxation Committee was called to order by Chairman Ramirez on January 8, 1987, at 9 a.m. in Room 312 B of the State Capitol.

ROLL CALL: All members were present with the exception of Rep. Harrington, who was excused by the Chairman.

DEPARTMENT OF REVENUE PRESENTATION ON FEDERAL TAX REFORM: Dan Bucks, Deputy Director, DOR, told the Committee that the recently enacted federal tax reform law provided the most sweeping changes in tax reform since 1954. He said the Internal Revenue Code had been relabled the Internal Revenue Code of 1986.

Mr. Bucks advised committee members that he would attempt to explain how this legislation affected federal and state taxes paid by Montanans, in terms of total numbers. He said the new tax law eliminated and/or reduced various tax bases, deductions, and/or exclusions, which were estimated to be revenue-neutral at the federal level. Mr. Bucks explained that this action increased Montana state taxes, as they are tied to the federal tax base, but that it did not increase rates, personal exemptions, and standard deductions. He stated that, in actuality, Montanans are net gainers in the general tax scheme.

Mr. Bucks said capital gains, which were formerly taxed at 60%, would now be fully taxed, and that the state anticipated an increase in state revenue as a result of these changes. He told committee members that DOR made a presentation to the Revenue Oversight Committee on November 14, 1986, estimating a state tax liability increase for individuals and corporations of $43.5 million, and a net decrease of $8 million for individuals and corporations.

Mr. Bucks read from page 4 of his Impact of Federal Tax Reform on Montana and Montanans (Exhibit #1) and explained graphs contained in the report. He said the DOR uses a broad definition for income, called expanded income. He stated it is a better measure of ability to pay and doesn't change its significance in response to change in tax law, as well as a means of measuring that remains static.

Mr. Bucks told the Committee the term "old law" refers to existing Montana state income tax law and the old federal tax law, and that "current law" refers to existing Montana state income tax law and the new federal law, effective in 1988.

He advised committee members that the DOR used a mean of 28,800 households in the state, of equal size and said statistics were somewhat skewed for the lowest income group because of the mixed composition and yet undefined information. He said the first three charts state changes in dollars and the remaining three, changes in percentages.

QUESTIONS FROM THE COMMITTEE: Rep. Ream asked Dan Bucks how Montanans would be net gainers with the recent tax changes. Mr. Bucks replied he had no complete answer, but that he knows the numbers and suspects the gain is due to the national scheme, a mix of economics, level, and composites of income and family size.

Rep. Sands asked Dan Bucks what individuals would pay in Montana income tax for CY88. Mr. Bucks replied Montana taxpayers paid $713 million in FY84 which, used as a data base, could result in a reduction of up to 15.5%. he added that CY88 is a year of provisional change because of the new tax law, making it difficult to provide an accurate estimate.

Mr. Bucks said DOR uses three types of information to estimate tax changes: 1) the income levels of Montanans-what kind and how it is distributed; 2) tax law information; 3) assumptions about taxpayer responses, available from the Joint Subcommittee on Taxation. He stated DOR hasn't projected that distribution, as it would be overwhelming to estimate detailed changes and that is why his department used 1984 as a tax base. Mr. Bucks added that he believed this was the firmest foundation on which to base figures.

Rep. Harp asked Mr. Bucks if it would appear that corporations and small business would experience an increase of $44 million in taxes because of the new federal tax law changes, and if middle-class wage earners would be similarly affected. Mr. Bucks replied that wage earners would be affected less, on the average, and that the most affected will be those who had a lower than average effective tax rate prior to the new changes.

Mr. Bucks said he could not comment on the tax situation of small corporations versus that of larger corporations, because of insufficient data, but did comment that it is a very complicated issue. He stated that repeal of investment credit does appear to focus on small corporations. Mr. Bucks told the Committee corporations will have to make accounting changes to capitalize certain deductions which are currently expensed, and certain gains from installment sales previously deducted over a period of time.

Rep. Koehnke asked Mr. Bucks if those taxpayers who have been choosing to take standard deductions will benefit more from the changes than those who choose to itemize. Mr. Bucks replied it appeared they would.

Rep. Gilbert asked how corporate accounting rules would be affected. Mr. Bucks replied that the income of subchapter S corporations passes to the individual and is not paid on the corporate side. He added that regular corporations received increases, but a more specific answer would require further research on his part.

Rep. Asay asked Mr. Bucks if this situation were a result of tax incentive changes or of excluding certain formerly deducted costs. Mr. Bucks replied that the general principles of ordinary and necessary expense of doing business still apply and are not affected, but that some specific preferences were expanded upon and/or liberalized, while others were deleted. Mr. Bucks stated he did not entirely understand the process, adding that the joint committee on revenue estimating may want to look at different sectors of industry which were previously taxed at very different rates. He told the Committee congress was attempting to bring these rates closer together.

Rep. Hoffman asked how capital gains were treated as a result of the new tax law. Mr. Bucks replied all capital gains are taxed now.

Rep. Hoffman asked, if the Department could come up with more realistic figures for its estimates if it had more time. Mr. Bucks replied the Department could always use additional time and staff, but that he believed the numbers would not change significantly. He said a governmental consultant group/advisory commission came out with numbers close to those of the DOR.

Rep. Harp asked what the difference is between expanded income and personal income. Mr. Bucks replied that expanded income does not include transfer payments such as social security and public assistance, while personal income does. He stated that most social security and similar payments, are not shown on tax returns, adding that expanded income is the best information available from tax returns.

Rep. Patterson asked Mr. Bucks if most states would realize greater withholding or a decrease. Mr. Bucks replied that, beginning January 1, 1987, both state and federal tax tables changed, and the net effect should be a significant decrease in the amount withheld, in most instances. He stated that wage earners should be in a favorable situation.

Rep. Asay asked at what point withholding stabilizes. Mr. Bucks replied that Chairman Ramirez had already requested this information and the data is being compiled.

Rep. Sands asked Mr. Bucks why Montana taxpayers experienced such a decrease in federal taxes. Mr. Bucks replied Montanans on the average don't have as much income to be affected. He told committee members an example of eight taxpayers (put together by a group of accountants, wherein all eight were utilizing exclusions and deductions allowed by the old tax), showed such taxpayers would be greatly affected. He said those utilizing standard deductions would be less affected.

Rep. Ream asked what effect federal tax changes would have on the mean used by the DOR. Mr. Bucks replied it would reduce the variable at given income levels, as some would go up and others would go down, but it would be an improvement toward tax equity. He said DOR must still look at the average effective rate prior to tax reform, as well as post-reform.

Rep. Ream asked how the mean would be affected in the area of corporate tax. Mr. Bucks replied he did not have enough information to address the question at that moment.

Rep. Ellison asked if the changes would affect the amount of capital available in Montana. Mr. Bucks replied that the national experts can't seem to answer this question and that there has been great debate on the outcome. He told Rep. Ellison the question is extraordinarily difficult and complicated to answer, but that history would tell.

Chairman Ramirez asked if there would be problems adjusting to eliminated windfall and if DOR had information on how the actual rate structure would be affected, other than using increments of 10%. Mr. Bucks replied he did not have that information at that moment and would need to confer with his staff. He added that it would be like trying to compare apples and oranges.

Mr. Bucks told Chairman Ramirez the rate structure is like comparing tax income before and after changes, and that reform spread income among many different brackets, changing the measuring stick of income and the distribution of taxpayers. He stated he was willing to work with the Committee in this extremely complicated situation.

Chairman Ramirez stated that if DOR used the average windfall tax increase, it would need to ascertain whether it had the necessary data to make an informed decision on the adverse impact of the new tax reform, to an estimated number of taxpayers. Mr. Bucks replied he could generate information on the distribution levels, and said averages are not all the Committee needs and/or wants.

Chairman Ramirez asked if assumptions on capital gains were compared to those of the Vasquez Policy Economics Group, a private consulting firm in Washington, D.C. Mr. Bucks replied that information is somewhat spelled out on page 3 of the DOR report, and told Chairman Ramirez the DOR stayed with the same assumptions Congress relied upon for its estimates.

Chairman Ramirez asked about the basic indicators from the data on page 5 of the DOR report. Mr. Bucks replied CY87 estimates showed the increase in state taxes for individuals and corporations would be less, and would appear to be closer to the levels for CY86, than those for CY88. He stated he did not have the figures on the exact differences.

Chairman Ramirez asked what would happen to net income fade if the federal government were to make a significant increase in rates by CY88. Mr. Bucks replied benefits from the federal rate reduction would be removed. He added that DOR is just completing work on the Governor's figures.

Chairman Ramirez asked if it were difficult to obtain accurate information and if data were insufficient on the corporate side. He also asked if DOR had any suggestions to correct this situation. Mr. Bucks replied he did not have much hope on the corporate side, as key information is contained in manual files of great volume. He said that, in his opinion, the information available to DOR is as good as an excellent data base and that the key difference will be to apply different assumptions than those chosen by DOR, to the data base. Mr. Bucks urged the LFA to understand what the different experts are saying about the ultimate effect to the taxpayers.

Dan Bucks continued, and told the Committee that DOR can respond effectively to its data base. He said the key in the subcommittees is to ask whether we are asking the right question and understanding the problem correctly. He asked subcommittees to make their requests for assistance through the DOR director's office.

OTHER BUSINESS: Rep. Sands asked if Taxation Committee would hold an overall hearing for the public on tax issues. Chairman Ramirez replied that meeting would be held on

Monday, January 19, at 7 p.m., in the old Supreme Court chambers of the Capitol. He stated interested persons would be notified via a press release, so that they would have an opportunity to voice their opinions at the meeting.

ADJOURNMENT: There being no further business before the Committee, the hearing was adjourned at 10:25 a.m.

Jack Ramirez

Representative Jack Ramirez,
Chairman

DAILY ROLL CALL

HOUSE TAXATION COMMITTEE

50th LEGISLATIVE SESSION -- 1987

Date 1-8-87

NAME	PRESENT	ABSENT	EXCUSED
REP. RAMIREZ	✓		
REP. ASAY	✓		
REP. ELLISON	✓		
REP. GILBERT	✓		
REP. HANSON	✓		
REP. HARP	✓		
REP. HARRINGTON			✓
REP. HOFFMAN	✓		
REP. KEENAN	✓		
REP. KOEHNKE	✓		
REP. PATTERSON	✓		
REP. RANEY	✓		
REP. REAM	✓		
REP. SANDS	✓		
REP. SCHYE	✓		
REP. WILLIAMS	✓		

CS-30

Ex. 1

EXHIBIT #1
DATE 1-8-87
DOR - Fed Tax Reform

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.

<u>Information Behind the Estimates</u>

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 <u>before</u> 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)

	STATE	FEDERAL	TOTAL
Individuals	$ 37.48	$ (89.12)	$ (51.64)
Corporations	6.09	37.69	43.78
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)

	STATE	FEDERAL	TOTAL
Individuals	$ 37.48	$(110.31)	$ (72.83)
Corporations	6.09	37.69	43.78
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)

Fiscal Year	Individuals	Corporations	Total
1987	$ 4.40	$ 1.07	$ 5.47
1988	22.58	4.72	27.30
1989	39.83	6.21	46.04
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 overweigh 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.

Version I

CHANGE IN INCOME TAXES : OLD LAW TO CURRENT LAW

		Absolute Change			Percentage Change		
		Graph IA	Graph IB	Graph IC	Graph ID	Graph IE	Graph IF
Total Number of Households	Income Group	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law	Federal Old Law to Current Law	State Old Law to Current Law	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%	1.38%

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.

Version II

CHANGE IN INCOME TAXES : OLD LAW TO CURRENT LAW

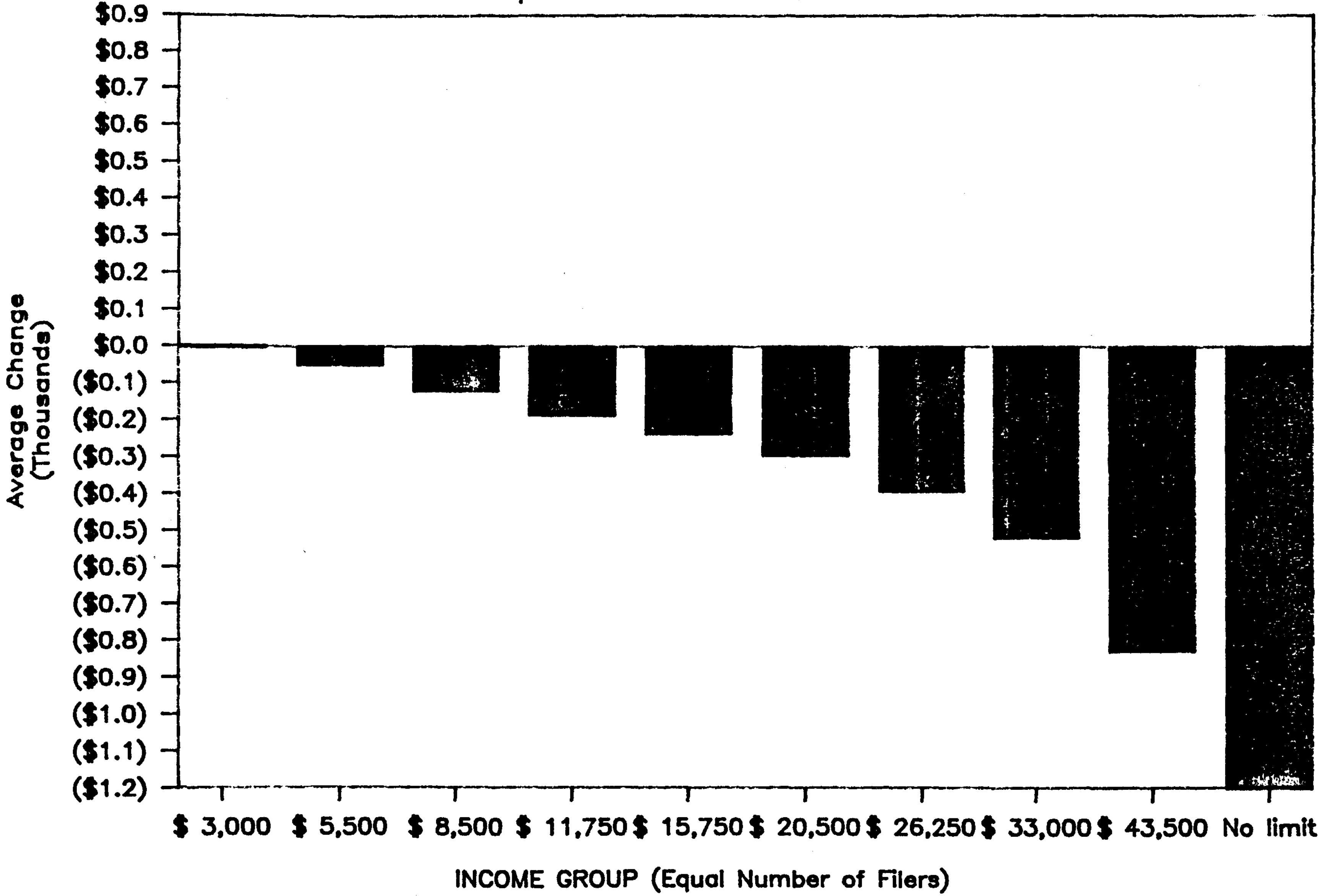
		Absolute Change			Percentage Change		
		Graph IIA	Graph IIB	Graph IIC	Graph IID	Graph IIE	Graph IIF
Total Number of Households	Income Group	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law	Federal Old Law to Current Law	State Old Law to Current Law	Total Old Law to Current Law
========	=====	=======	========	========	========	========	========
28887	$ 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	-391.31	79.32	-311.99	-17.50%	13.60%	-11.06%
28882	$ 33,000	-518.04	124.70	-393.34	-16.59%	15.17%	-9.97%
28880	$ 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.

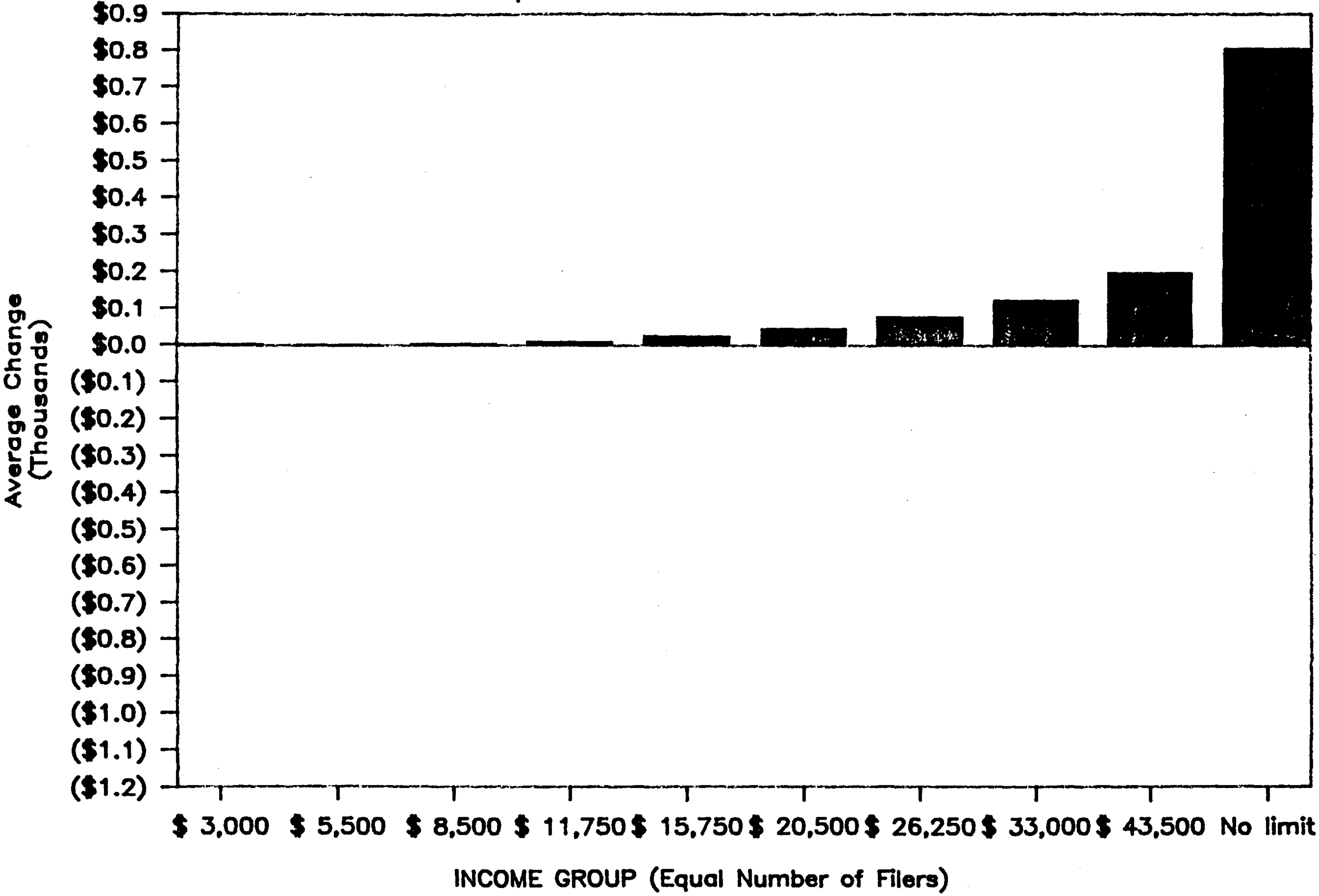
CHANGE IN FEDERAL INCOME TAXES

Graph IIA Old Law to Current Law



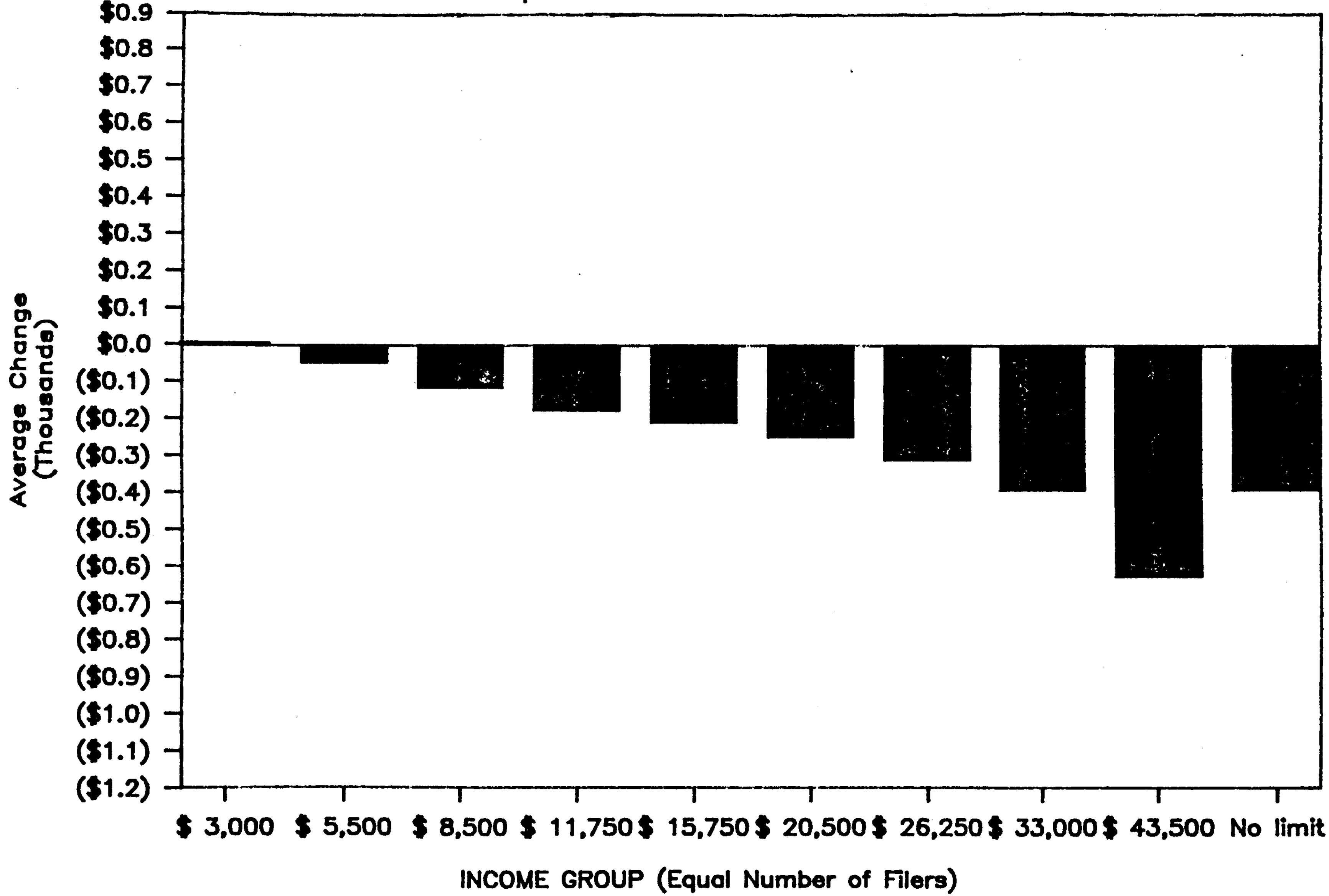
CHANGE IN STATE INCOME TAXES

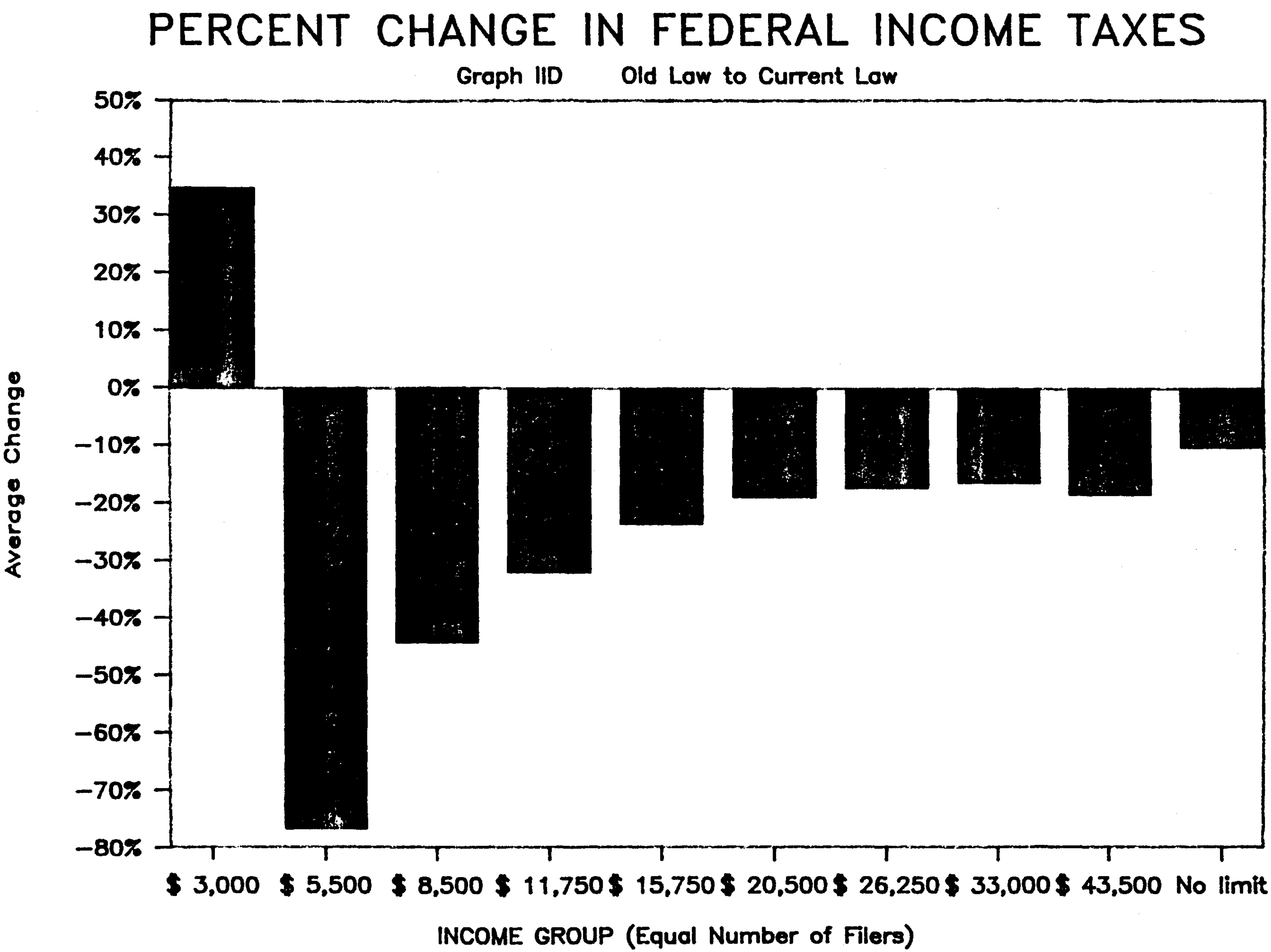
Graph IIB   Old Law to Current Law



CHANGE IN TOTAL INCOME TAXES

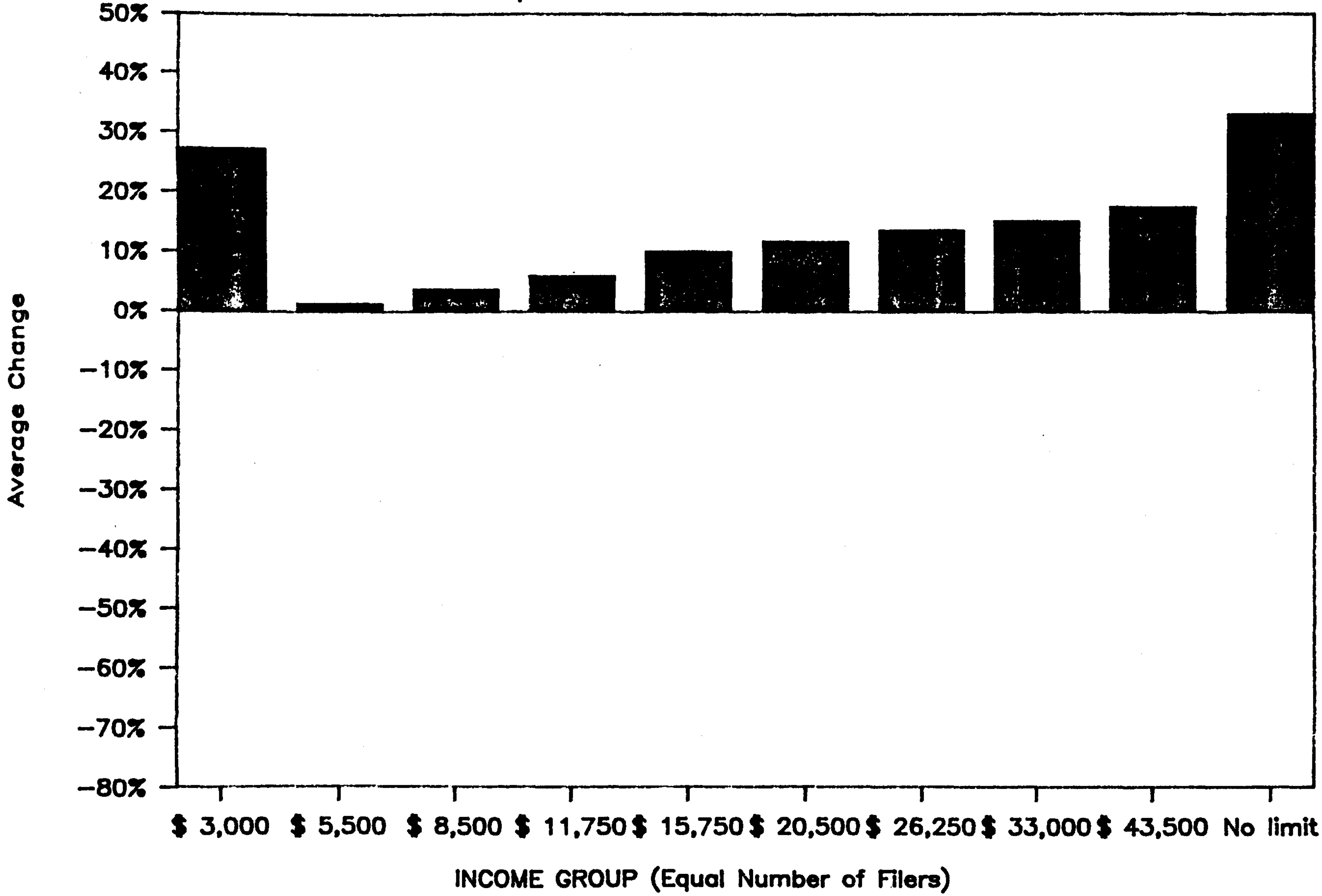
Graph IIC Old Law to Current Law




PERCENT CHANGE IN FEDERAL INCOME TAXES
Graph IID Old Law to Current Law
Average Change
50%
40%
30%
20%
10%
0%
-10%
-20%
-30%
-40%
-50%
-60%
-70%
-80%
$ 3,000
$ 5,500
$ 8,500
$ 11,750
$ 15,750
$ 20,500
$ 26,250
$ 33,000
$ 43,500
No limit
INCOME GROUP (Equal Number of Filers)

PERCENT CHANGE IN STATE INCOME TAXES

Graph IIE Old Law to Current Law



PERCENT CHANGE IN TOTAL INCOME TAXES

Graph IIF   Old Law to Current Law