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To: Mike Kadas, Director  
From: Dan Dodds, Senior Economist  
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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

Percentiles	2016 Income Range	Number of Returns	Federal Income Tax Paid by Montanans					Montana Income Tax				
			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 - 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	-\$15.10	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			

