



Dan Bucks
Director

Montana Department of Revenue



Brian Schweitzer
Governor

July 11, 2008

The Honorable Jim Peterson, Chairman
Revenue and Transportation Interim Committee

Subject: Comments on Draft Federal Conformity Bills (LC999 and LC9998)

Dear Chairman Peterson:

I am transmitting, with this memo, comments prepared by Brenda Gilmer, Senior Tax Counsel, related to the draft bills from the federal conformity study being undertaken by your committee. Ms. Gilmer makes a number of important comments and suggestions that we hope will aid the committee with respect to this study.

Sincerely,

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Montana Department of Revenue



Brian Schweitzer
Governor

Memorandum

TO: Dan R. Bucks, Director

FROM: Brenda Gilmer, Senior Tax Counsel *BG*

DATE: July 9, 2008

SUBJECT: Technical issues related to LC 9997 and LC 9998 draft federal conformity bills

Overview

Two bill drafts being considered by the Revenue and Transportation Interim Committee, LC 9998 and LC 9997, stop the automatic conformity to federal tax law changes to Internal Revenue Code (IRC) sections that are incorporated into Montana law. This memo addresses technical issues related the bills' provisions – it does not address taxpayer effects, which are dependent on the frequency and substance of federal tax enactments.

LC 9998 fixes specific references to the Internal Revenue Code in chapters 30 (individual income tax) and 31 (corporation license and income tax) to the Internal Revenue Code "as it read" on December 31, 2008, immediately preceding the 2009 session.

LC 9997 fixes references to the IRC using an "as enacted" format,¹ but brings in federal amendments that are effective between January 1, 2009 and December 31, 2010, subject to prospective or retroactive changes by the 2011 Montana legislative.

LC 9997's format, while it incorporates federal changes that occur during the following two-year interim period, does so only for that one interim period. Affirmative action

¹ (13) (a) "Internal Revenue Code" means the Internal Revenue Code of 1986, ~~as amended, or as it may be labeled or further amended~~ as enacted prior to January 1, 2009. A provision of the Internal Revenue Code that was enacted into law prior to January 1, 2009, but that was not effective on January 1, 2009, is effective for the purposes of this chapter on the same date on which the provision becomes effective for federal tax purposes. ~~References to specific provisions of the Internal Revenue Code mean those provisions as they may be otherwise labeled or further amended.~~

(b) A provision of the Internal Revenue Code that is enacted into law between January 1, 2009 and December 31, 2010, is subject to subsequent legislative action to modify or not use the provision for the purposes of this chapter, including, retroactive applicability of the legislative action relating back to December 31, 2008."

would be required by the 2011 legislature to enact a further automatic conformity for federal changes that would occur between January 1, 2011 and December 31, 2012. Federal tax changes that are enacted during the year the legislature meets, and during the following calendar year, become a permanent part of Montana tax law unless the following legislature affirmatively acts to reject them.

A third option suggested by the Department of Revenue, for which there is no draft, would make interim federal changes temporarily effective for the interim years, but require affirmative adoption to continue them to later years:

(13) (a) "Internal Revenue Code" means the Internal Revenue Code of 1986, ~~as amended, or as it may be labeled or further amended~~ as enacted prior to January 1, 2009. A provision of the Internal Revenue Code that was enacted into law prior to January 1, 2009, but that was not effective on January 1, 2009, is effective for the purposes of this chapter on the same date on which the provision becomes effective for federal tax purposes. ~~References to specific provisions of the Internal Revenue Code mean those provisions as they may be otherwise labeled or further amended.~~

(b) A provision of the Internal Revenue Code that is enacted into law between January 1, 2009 and December 31, 2010, is effective for tax years 2009 and 2010 on the same date it is effective for federal tax purposes."

Detail

Title changes: The three Montana tax types affected by the bills' provisions deviate from the IRC in material ways. The purpose of both drafts is only to stop the current (and historic) practice of automatically conforming to federal tax changes, not to override any present-law deviations from the IRC. While the text of the bills is not inconsistent with this more limited purpose, because some of the Montana deviations come about from case law rather than clear, unambiguous statutory language (individual income tax -- disallowance of deduction for self-employment taxes²; corporation license tax -- disallowance of bad debts³ and bank bond⁴ reserves and

72-16-905. Estate tax -- how computed. The tax imposed upon the transfer of each estate is equal to the maximum tax credit allowable for state death taxes against the federal estate tax imposed with respect to the portion of the decedent's estate having a taxable situs in this state. It is the purpose and intent of this part to impose only those additional taxes that may be necessary to give this state the full benefit of the maximum tax credit allowable against the federal estate tax imposed with respect to a decedent's estate that has a taxable situs in this state. If only a portion of a decedent's estate has a taxable situs in this state, the maximum tax credit must be determined by multiplying the entire amount of the credit allowable against the federal estate tax for state death taxes by the percentage that the value of the portion of the decedent's estate that has a taxable situs in this state bears to the value of the entire estate.

History: En. Sec. 2, Ch. 48, Ex. L. 1933; re-en. Sec. 10400.3a, R.C.M. 1935; amd. Sec. 1, Ch. 360, L. 1969; amd. Sec. 1, Ch. 28, L. 1971; amd. Sec. 12, Ch. 365, L. 1974; R.C.M. 1947, 91-4411(part); amd. Sec. 29, Ch. 9, Sp. L. May 2000.

² *Baitis v. Dept. of Revenue*, 2004 MT 17, 319 Mont. 292, 83 P.3d 1278.

³ *First Federal Savings & Loan Association of Billings v. State Tax Appeal Board* (1975), 167 Mont. 33, 535 P.2d 183.

⁴ *Mont. Nat'l Bank of Roundup v. Dept. of Revenue* (1975), 167 Mont. 429, 539 P.2d 722.

disallowance of premerger losses,⁵), the titles should be changed to more clearly state the limited purpose of the proposed legislation.

Forms and software. Under the fixed date version (LC 9998), the incorporated IRC provisions that would apply to the 2009 tax year (return due in spring of 2010) and 2010 tax years (return due in spring of 2011), except for changes made by other 2009 session enactments, would be fixed by the end of the 2009 session.

- While later federal tax changes would not affect how Montana tax liability is determined, the Department would likely have to expand its form instructions and web-site information to highlight and explain the federal provisions that do not apply in computing Montana tax liability.
- The Department would have to determine whether to continue to refer to federal form line numbering and amounts or, after consultation with other non-automatic change conforming states, to significantly change the Montana income tax forms.
- Tax software developers would know how to complete a Montana income tax return at a much earlier date.

Under the two-year interim conformity version (LC 9997), little would change from present conditions for the 2009 tax year. Form and instruction completion, software development, stakeholder outreach and education, and web-site information development would be affected by ongoing federal changes just as they now are. By the time the legislature meets in 2011, the 2009 returns would be filed, taxes paid, and refunds issued. Retroactive rejection of any 2009 federal amendment that affects a significant number of Montana taxpayers for that tax year would be difficult.

For the 2010 tax year, because the tax returns will not be filed by the time the 2011 legislature begins meeting, the prospect exists, at least theoretically, that 2009 and 2010 federal amendments would be rejected for computing tax liability for the 2010 tax year. Because of the spring filing deadlines and the fact that forms must be printed and software developed long before January 1, 2011, however, the prospect of retroactive rejection is probably dim. Most likely, under LC 9997, the effect of computing Montana tax liability without any 2009 and 2010 federal amendments that are affirmatively rejected by the 2011 legislature would apply only to tax years 2011 and forward.

The third alternative suggested by the Department would make any 2009 and 2010 federal amendments that were affirmatively approved by the 2011 legislature applicable for tax years 2011 and forward. Any interim changes that were not affirmatively continued would result in a change from the prior year effective for the 2011. This alternative would provide somewhat more certainty, particular for the 2010 tax year, for developing forms and software. This alternative would likely require form changes to reconcile 2009 and 2010 changes that were not carried forward.

Historically, most Montana tax changes have followed an effective date convention wherein they do not appear on filed returns until the following spring.

⁵ *GBN, Inc. v. Dept. of Revenue* (1991), 249 Mont. 261, 815 P.2d 595.

Montana Estate Tax Effects. Federal changes to estate and gift taxes are expected before 2010 when, for decedents dying during 2010, the estate tax is temporarily repealed (as a result of 2001 legislation, the top federal rate has been decreasing each year but will remain at 45% for 2008 and 2009). After 2010, the 2001 amendments are currently set to expire and estates would again become subject to the federal estate tax with a top rate of 55%.

Historically, in computing federal estate tax, a credit was allowed for state inheritance or estate taxes, IRC §2011, and it is scheduled to come back in 2011. The credit is important to states because it has no effect on the total amount of taxes paid by taxpayers, only the distribution of taxes between the federal and state treasuries.

While Montana's estate tax is equal to the credit allowed the estate under federal law⁶ (our inheritance tax was repealed in 2002), between 2002 and 2005, the federal credit was phased out in 25% increments and has been 0 since 2006 (a deduction has been allowed under IRC 2058 in computing the amount of the estate subject to federal tax).

Inheritance and Estate Tax Collections	
FY2000	\$19,038,785
FY2001	\$20,285,642
FY2002	\$13,816,144
FY2003	\$13,305,983
FY2004	\$11,431,103
FY2005	\$4,190,613
FY2006	\$1,773,169

Because both bill drafts amend only Title 15 sections and not 72-16-904 and -905, the temporary repeal of the estate tax in 2010 (enacted in 2001) should not be read to affect the return to our incorporating the federal credit for state taxes and resurrection of a Montana estate tax in 2011 even if LC 9997 were adopted and the provisions of the IRC, as enacted on or before December 31, 2010, became the fall-back rule. As an exercise in caution, a section could be added specifying that nothing in the bill is intended to affect the state estate tax provided in 72-16-904 and -905.

IRC Transition, Grandfather, and Temporary Provisions. In general, the "as it read on" formulation of conformity can be dangerous because it does not address vagaries of federal transition provisions, grandfather clauses, and temporary provisions. LC 9997's alternative formulation, using "as enacted" language and specifying the intent about effective dates provides greater clarity. Both the "as it read on" and the "as enacted on" formulations are problematic for any federal code section that contains cross-references

⁶ **72-16-904. Estate tax imposed.** An estate tax is imposed upon the transfer of the estate of every decedent leaving an estate that is subject to the federal estate tax imposed by the United States of America under the applicable provisions of the Internal Revenue Code and that has, in whole or in part, a taxable situs in this state.
 History: En. Sec. 2, Ch. 48, Ex. L. 1933; re-en. Sec. 10400.3a, R.C.M. 1935; amd. Sec. 1, Ch. 360, L. 1969; amd. Sec. 1, Ch. 28, L. 1971; amd. Sec. 12, Ch. 365, L. 1974; R.C.M. 1947, 91-4411(part); amd. Sec. 28, Ch. 9, Sp. L. May 2000.

to other code sections. As happened when the federal Investment Tax Credit was kept alive in Montana (former sections 15-30-162 and 15-31-123, repealed Sec. 4, Ch. 159, L. 2003) "as it read" before its federal repeal, the way something reads in a particular year starts becoming nonsensical as some, but not all, internal cross-referenced sections are amended or repealed or the entire structure of a cross-referenced section changes. Future drafters could avoid most problems experienced with the ITC by paying careful attention to and specifically addressing any internal cross-references in IRC sections that are frozen in time.

Case law and federal disparity. A 1982 Montana Supreme Court decision, *Baker Bancorporation, Inc.*,⁷ held that for corporation license tax purposes, a federal deduction is allowed unless the Montana legislature expressly excludes it. This has created an automatic "judicial" conformity provision that should be specifically dealt with to prevent confusion about what corporation deductions are allowed.⁸ A new bill section should be added specifying that the holding in *Baker Bancorporation* is being prospectively overruled, rather than relying on the equivalent of implicit repeal. In addition, 15-31-114 should be amended to either tie to federal deductions as of the appropriate date, except for the historic deviations, or to provide discrete enumerated Montana corporation deductions along with a statement of clear legislative intent that the deductions listed in 15-31-114 are the only allowable deductions notwithstanding any current or future federal deductions or the incorporation of the federal definition of "gross income" in 15-31-113."

Responsibility for conformity research. The need for significant and timely research about federal tax changes and their effect on Montana's income tax system would increase if automatic federal conformity ceases. Neither bill specifies who would provide the research or a timetable for providing it.

As noted in Jeff Martin's memo presented at the February 2008 meeting, entitled "*HJR 61 Review of State Conformity with Federal Income Tax Laws*, 18 states and the District of Columbia use "rolling conformity," while 18 states conform as of a fixed date. Those using a fixed date are Arizona, California, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Main, Minnesota, Nebraska, North Carolina, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, and Wisconsin. Many of the states report on federal conformity changes after they are adopted; only the California Franchise Tax Board posts its analysis of federal tax law changes on its web-site in advance of conformity legislation. This report would be an available and useful tool for reporting changes that could be considered by the Montana legislature.

⁷ *Baker Bancorporation, Inc. v. Dept. of Revenue* (1982), 202 Mont. 94.

⁸ Section 15-31-114, MCA, corporate deductions, has never been amended to conform with or overrule the *Baker Bancorporation* decision. Would generally terminating the automatic update of federal changes implicitly repeal the holding in the *Baker Bancorporation* decision? If not, if a section of the IRC that provides for a deduction is not specifically mentioned in 15-31-114, but it was (or would be) allowed under the *Baker Bancorporation* rationale, what version of the IRC section that provides for the federal deduction would apply -- the version of the code section "as it read" or "was enacted" and effective on the relevant date under the particular bill?