

MONTANA TAXPAYER



MONTANA TAXPAYERS ASSOCIATION

HELENA, MONTANA

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Upcoming Meetings

Tuesday & Wednesday, June 1 & 2 -- [Legislative Council](#)

Wednesday, June 2 – Rule Hearings

[MAR Notice No. 42-2-829](#); 1:00pm

[MAR Notice No. 42-2-830](#); 2:00pm

[MAR Notice No. 42-2-831](#) – 2:30pm

Thursday, June 10 – [Education and Local Government](#)

Monday & Tuesday, June 14 & 15 - [Legislative Finance](#)

Monday, June 21 – [Land Board](#)

Tuesday, June 22 – [Legislative Computer System Planning](#)

Wednesday, June 23 – [Legislative Audit](#)

Thursday & Friday, June 24 & 25 - [State Administration & Veterans' Affairs](#)

Monday, June 28 – [Children, Families, Health & Human Services](#)

Tuesday, June 29 – [Economic Affairs](#)

Tuesday & Wednesday, June 29 & 30 - [Law and Justice](#)

Wednesday & Thursday, July 7 & 8 – [State-Tribal Relations](#)
(to be held in Browning)

Thursday & Friday, July 22 & 23 – [Environmental Quality](#)

Monday & Tuesday, July 26 & 27 – [Water Policy](#)

Wednesday & Thursday, July 28 & 29 – [Energy and Telecommunications](#)

Monday & Tuesday, August 2 & 3 – [Revenue and Transportation](#)

Monday & Tuesday, August 16 & 17 - [Education and Local Government](#)

Wednesday, August 25 – [Legislative Computer System Planning](#)

Please check our website [calendar](#) or the [Legislative Calendar](#).

Montana Taxpayer Association Website –

[www.montax.org](#)

We have started adding new information to our website in preparation of the 2011 Legislative Session. Agency documents for the Executive Planning Process (EPP) and some agency legislative proposals have been included. We have also provided links to new information recently posted to both the Legislative Fiscal and Legislative Services Divisions' websites.

EPP – Agency Request Detail - Revenue

In last month's newsletter we reported on the Executive Planning Process (EPP) for the 2013 Biennium Budget. This month we take a closer look at the requests of the Department of Revenue. The department is requesting exemption from any mandatory cuts or vacancy savings

and a \$4 million increase in compliance funding. The Department claims that for every \$1 spent, \$8 is brought in. Since 2004, the department's budget has increased from \$30.5 million to \$52.4 million. This excludes one-time expenditures for computer upgrades and transfers to local governments so it should be fairly representative of ongoing expenses.

The justification, in part states: "This proposal is to fully fund personal services in Business and Income Tax Division (BITD) in order to protect the general fund revenue base. Fully funding these personal services ensures that the state's mandatory obligation to make certain that all taxes that are owed are correctly paid can be met. As the department has reported in the past, for every dollar spent in the BITD, eight dollars are returned in audit collections (\$8 to \$1 audit ROI). The converse of the equation is also true. For every dollar that is reduced from the division's budget, eight dollars are not collected. Not only is there a direct return on investment (ROI) from the division's tax compliance efforts, there is a direct return as well. The indirect return is based on the premise that if taxpayers know that the revenue agency is properly looking after the state's general fund by ensuring that all taxpayers are paying their fair share, taxpayers are more willing to voluntarily comply with the tax law. But if taxpayers believe that the revenue agency isn't able to fully enforce the state's tax laws, they begin to fall voluntarily out of compliance. The true effect of voluntary compliance is not easily quantified but can be considerable. To maintain the \$8 to \$1 audit ROI it is imperative the division remain fully staffed to meet mandatory tax compliance obligations.

"If BITD is exempted from vacancy savings it will be able to continue to produce an audit ROI of roughly \$8 to \$1 over the 2013 biennium and no downward adjustment to the revenue estimate will be required. If BITD is not exempted from vacancy savings, the 2013 biennium revenue estimate will need to be reduced by \$8 for every dollar of vacancy savings applied to BITD."

Besides being exempt from any vacancy savings requirements or cost savings the division requests "\$4 million in general fund and 29 FTE in the 2013

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Healthcare - Mike Foster, Billings	Utilities - Tom Ebzery, Billings
Ind. Power Producers - David Hoffman, Helena	Wood Products - Kent Jones, Columbia Falls

Biennium for additional staff to continue to close Montana's tax gap. Approval of this proposal will better ensure that Montana receives the tax that is due based on Montana statute. This proposal will generate additional revenues estimated at \$15 million for the 2013 Biennium (\$5 million in FY2012 and \$10 million in FY2013). Further, it will generate an additional \$30 million for the 2015 Biennium. If funded the \$15 million should be added to the 2013 Biennium estimates.

"Generally the tax gap is measured as the difference between taxes owed on legitimate, legal activities and taxes paid voluntarily and in a timely manner. Recent compliance data shows that a disproportionate share of this tax gap is owed by non-resident and out-of-state companies. If the tax gap remains unaddressed, it imposes an unfair burden on those who pay on time and accurately. It erodes public confidence in the voluntary tax system; encourages further non-compliance with tax law and it reduces revenue need for the state to provide essential services." (Agency Detail Request, Department of Revenue, Version 2013-5801-B10).

According to the IRS, "the tax gap can be divided into three components: nonfiling, underreporting and underpayment. Nonfiling occurs when taxpayers who are required to file a return do not do so on time. Underreporting of tax occurs when taxpayers either understate their income or overstate their deductions, exemptions and credits on timely filed returns. Underpayment occurs when taxpayers file their return

but fail to remit the amount due by the payment due date.

Of these three components, underreporting of income tax, employment taxes and other taxes represents about 80 percent of the tax gap. The single largest sub-component of underreporting involves individuals understating their incomes, taking improper deductions, overstating business expenses and erroneously claiming credits. Individual underreporting represents about half of the total tax gap. Individual income tax also accounts for about half of all tax liabilities." (Understanding the Tax Gap FS-2005-14, March 2005)

Note that despite the statistics from the findings of the IRS, the tax gap is due to nonfiling and underreporting by individuals, it appears Montana is unique among the states as our gap is due to out-of-state businesses and non-residents. This dichotomy can be explained by the department's broad interpretation of what revenues constitute "economic substance" or a taxable event in Montana.

This broad reading of Montana statute was first raised when the department chose to adopt a rule found only in a handful of states that outbound 1031 exchanges occurring in Montana remain taxable in Montana until the exchange ended in a taxable event. Since that time those states have changed their views on this issue.

On another issue, recently, the Council of State Taxation (COST) issued the following news release: after "nearly a year of deliberation, the MTC Executive Committee voted earlier this week to send the MTC's proposed model mobile workforce statute back to committee. The vote to recommit the bill to the MTC's Uniformity Committee was six in favor, three opposed and two abstaining. The vote followed a passionate presentation by Montana Revenue Director Dan Bucks.

"Director Bucks objects to MTC proposal in concept and in detail. Conceptually, he argues that the proposal should apply only to withholding and that it should have a dollar threshold (not a day threshold) analogous to Montana's existing \$3,860 threshold. It is unclear why Director Bucks thinks that a withholding-only threshold set at his state's existing liability threshold would ease the current administrative burden. Director Bucks offered other objections to a day threshold, suggesting that a day threshold would lead to similar legislation in other areas of tax law and that "it is a roadmap to ruining state tax bases."

"Of course, several states already have day thresholds for nonresidents, including many that offer full reciprocity (i.e., a 365 day threshold), and they appear not to have been ruined as a result. Director Bucks provided a detailed example of how traveling doctors

would set up a Nevada corporation with 14 or 15 LLCs underneath and then transfer employees to a new LLC every 19 days to avoid withholding tax. Setting aside the absurdity of the example, neither the MTC proposal nor HR 2110 would excuse the employee from tax liability if the employee exceeds the day threshold; it is unclear how an example of illegal tax evasion has any bearing on the utility of voluntary model statute. Mr. Bucks summed up his view of the model statute by saying it is “a huge disappointment.” See letter to MTC from Department of Revenue at <http://www.mtc.gov/Uniformity.aspx?id=4622>

In conclusion, it appears that while pointing fingers at out-of-state companies and nonresidents makes a great sound bite, it does little for our open for business slogan. We certainly don't promote tax evasion, but we do want our tax system to be reasonable and sound.

Study of State Pension Plans

(Curt Nichols, Consultant for Montana Taxpayers Association)

In its May 19 meetings the State Administration and Veteran's Affairs Committee (SAVA) continued its inquiry of State pension plans. This study is authorized and funded through HB659 of the 2009 legislative session.

Committee narrows range of options under consideration

Buck Consultants, the committee's consulting actuaries, presented reports¹ on potential retirement plan design alternatives. The alternatives were rated based on a previous survey of committee member retirement program goals and financial risk aversion goals. The committee's highest priority retirement program goals leaned heavily in favor of continuation of some form of defined benefit plan:

- Employee retention
- Provision of death and disability benefits
- Professional investment management
- Lifetime income security
- Adequate income replacement

The committee's highest risk aversion goals leaned more toward defined contribution or floor plan forms:

- Costs not supported by tax revenue (added by consultant)
- Increases to pay, health or other benefit costs
- Low bang for the buck
- Contribution rate volatility
- High administrative costs

The consultants mapped the committee survey against 10 alternative plan designs, ranging from defined benefit to defined contribution, showing the interrelationship

¹ For copy of consultant report see:

http://leg.mt.gov/content/Committees/Interim/2009_2010/State_Administration_and_Veterans_Affairs/Meeting_Documents/May-19-2010-meeting/values-risks-initial-packet.pdf

between the plans' value and risk aversion. This mapping generated two options which combined higher value with lower risk: money purchase plan; combined reduced defined benefit and money purchase plan. The committee selected to have consultants pursue the money purchase plan and look at a revised defined benefit plan. Consultants will provide more detailed analysis on these two options to the committee at its June 24-25 meeting.

The options under consideration

The Money Purchase Plan (MPP) is a form of defined benefit plan. A highly simplified description is: employer and employee contribute to a fund (notionally unique for each employee) at preset contribution rates over the life of employment; interest is credited to the account at a rate (potentially variable and set by formula); at retirement the amount in the account is converted to an annuity for the retiree's benefit. The annuity (and corresponding risk) is maintained by the retirement fund. The interest rate used on the annuity is set by the state. The effect of such a plan on taxpayer risk depends on the details: interest crediting rate, annuity rate, and other factors. If the interest crediting rate is set too high or the annuity too rich the plan (taxpayer) is at increased risk as the interest accumulation in the account and the annuity payments are an employer obligation. Risk can be mitigated by varying the interest crediting rate and annuity rate to recognize investment results but this would have to be built into the 'contract' such that the rates can be legally changed.

A revised defined benefit plan would be a defined benefit plan like those currently used by the state for public employees except some features would be revised to limit the employer (taxpayer) funding volatility. Revisions could take the form of: lower benefit percentages; longer final average salary calculation periods; later retirement ages; increased early retirement discounts; reduced or eliminated GABA (post retirement benefit adjustment or COLA), increased employee contributions or other such factors.

Consultants will develop more detailed information about the selected options for the committee's next meeting.

Basic features of major current defined benefit plans

The two largest public employee retirements systems are Public Employees Retirement System (PERS) and Teachers Retirement System (TRS). State laws provide plan parameters that determine eligibility, contributions and benefits. The following table summarizes some of the more significant factors.

Retirement Plan Characteristics

	<u>PERS</u>	<u>TRS</u>
Eligibility for full benefit, either of the following		
Years of service	30	25
Age	60	60
Early retirement eligibility, benefit is discounted		
Years of service	25	
Age	50	50
Vesting	5yrs	5yrs
Retirement benefit percentage multiplier ¹	2.00%	1.67%
Contribution rates		
Employer	7.17%	9.85%
Employee	6.90%	7.15%
Income replacement rate at full benefit service years ²	60.00%	41.75%
Social Security income replacement rate ³	<u>39.00%</u>	<u>39.00%</u>
Risk free income replacement rate ⁴	99.00%	80.75%
Guaranteed annual benefit adjustment ⁵	1.50%	1.50%

¹ Percentage of highest average salary for each year of service. 1.78% for PERS less than 25 yrs.

² Number of years of service for full benefit times retirement percentage multiplier.

³ Average; depends on work history; rate higher for low incomes, lower for high incomes.

⁴ Retirement benefit guaranteed by state plan plus social security.

⁵ PERS employees hired before FY2008 receive 3%.

The above table also includes a calculation of the income replacement rate a retired beneficiary would receive. Since Montana governmental employees are typically covered by social security in addition to state retirement plans these income replacement rates are included. The combined income replacement is labeled the risk free income replacement as both the state plan and social security offer defined benefits with the employer assuming the risks. PERS employees currently have a risk free benefit guaranteeing them 99% income replacement when combined with Social Security and retiring with 30 years service [PERS 30 yr X 2%/yr=60% + SS =39%]. TRS employees currently have a risk free benefit guaranteeing them 81% income replacement when combined with Social Security and retiring with 25 years of service [TERS 25 yr X 1.67%/yr=41.7% + SS= 39%]. This comes at a cost as employer plus employee contributions are 29.4% of pay for TRS and 26.47% for PERS. Since full social security benefits are not available until age 66 there may be a considerable period for some state pension plan retirees between state retirement and social security retirement.

Action may reduce future risk but not current need for higher taxpayer contributions

The actions of the SAVAs committee to redesign retirement plans are prospective in their impact. The losses that have been incurred under the current plans will not be eliminated by a new plan; only future potential losses will be affected by the plan. This arises from the contractual nature of the retirement plans which implies that current employees have a contractual right to current benefits; only new hires are covered by the new plans. The \$3.7 billion (at end of FY2009) difference between the market value of PERS and TRS plan assets and actuarial accrued liabilities must be covered by higher investment returns and increased employer (taxpayer) contributions. Last fall actuaries for TRS estimated the employer contribution rate would more than double (to 20.43%) to make the system sound.

This would cost taxpayers \$70 million annually. The amount required for PERS is similar.

While the unfunded liability of the current plan will unlikely be cured by any plan change future risk can be reduced or eliminated so that we do not find ourselves again in another decade with taxpayers being required to contribute billions more. Careful attention to the details of the plan and ongoing monitoring are important to keep taxpayer burdens down. Past experience indicates that risks are asymmetric, i.e. the taxpayer is on the hook for the downside performance but the employee (through their representatives, the legislature, etc) is more effective at capturing the upside performance in enhanced benefits.

Needed reform gone bad: consumer agency is done deal (From the Montana Bankers Association)

Recently the U.S. Senate approved its version of financial reform by a vote of 59-39. Four Republicans voted "AYE" on final passage. In addition to the remaining 37 Republicans, two Democrats - Senators Maria Cantwell (D-Wash.) and Russ Feingold (D-Wisc.) - voted "NAY." Cantwell and Feingold felt the bill didn't go far enough to end "too-big-to-fail" as a matter of national policy.

"It's a tragedy that this 1,500-plus page bill - now moves forward," said MBA President Steve Turkiewicz. "These added costs will have a negative impact on bank lending among Montana banks which will stifle job creation. Not what our communities need at this time."

The MBA joined its fellow state bankers associations and the ABA in opposing final passage of the Senate bill. Turkiewicz noted that the effort was supposed to deal with the causes of the near-collapse of the nation's financial system beginning in September 2008. It is being touted by its supporters, including the Obama Administration as fixing the problems on Wall Street.

"It doesn't," Turkiewicz said. "In fact this terrible bill imposes at least 30 'new or improved' burdens and restrictions on Montana banks that had nothing to do with causing the financial crisis. Many of which may reduce credit availability to Montanans." "These new requirements will increase operating costs for banks, Montana consumers and small business owners. Thankfully, some of the worst ideas didn't emerge in the final version. Senators Tester and Baucus helped eliminate some of the most damaging proposals. Unfortunately there are too few Senate members who understand the basics of financial reform, and that this effort became so misdirected that it will severely hurt the profitability of traditional Montana community banks. It's just a travesty."

Ed Yingling, president of the American Bankers Association, was equally distressed. "The American Bankers Association has supported broad financial

regulatory reform since the beginning of this debate," Yingling said. "However, ABA and traditional bankers across the country oppose the legislation approved by the Senate because it now contains very negative provisions that will ultimately hurt American consumers, small businesses and the broader economy. "This bill contains some of the key reform principles that we support, but it also has been loaded down with provisions that will greatly undermine our banks' ability to provide credit and help create jobs in their communities. Many of these negative provisions have nothing to do with the financial crisis.

"Despite all the talk about this being a Wall Street bill, it, in fact, does tremendous harm to traditional banks on Main Street that had nothing to do with the crisis and that will now be less able to support the economy. This bill promised much-needed reform but has gone terribly wrong."

"In testimony before Congress, in correspondence with policymakers, and in our outreach to the press, ABA has consistently expressed our support for the key principles of reform. These include creation of a systemic risk council, creation of a strong mechanism for handling the failure of large institutions, ending the concept of too-big-to-fail, closing gaps in regulation and enhancing consumer protection.

"We have also continuously stressed that reform must be done right because if it is not, it will only set the stage for future bailouts, undermine thousands of traditional banks that had nothing to do with causing the financial crisis, hurt banks' ability to lend, and drive more financial business into poorly regulated firms and overseas."

The bill now goes to conference with the House where efforts will be made to deal with the many problems it contains. There is no timetable for further debate and action by the Congress.

NEW YORK (CNMONEY.com) *By Neil deMause, contributing writer - May 21, 2010* -- The [massive expansion of requirements](#) for businesses to file 1099 tax forms that was hidden in the 2,409-page health reform bill took many by surprise when it came to light last month. But it's just one piece of a years-long legislative stealth campaign to create ways for the federal government to track down unreported income. The result: A blizzard of new tax forms that the Internal Revenue Service will begin rolling out next year.

"It was actually something that we were following back under the Bush administration under the 2008 budget -- we started to see these kinds of rumblings about the 'tax gap' and whether or not businesses were paying their fair share," says Tom Henschke, president of the Pennsylvania-based SMC Business Councils, which was one of the first organizations to [call attention](#) to the

health care amendment when it was introduced last fall. "So two administrations can claim credit for this."

The first tax-reporting expansion was buried in a different bill, the Housing Assistance Tax Act introduced by House Speaker Nancy Pelosi and signed into law by President George W. Bush in July 2008. Best known for its first-time homebuyers' credit, the bill also created a new addition to the family of 1099 tax forms: the 1099-K. The 1099 is a catch-all series of IRS documents used to report non-wage income from a variety of sources like contract work, dividends, earned interest and pension distributions.

The new 1099-K aims to shine a light on a currently hard-to-track payment stream: credit cards. Starting in 2011, financial firms that process credit or debit card payments will be required to send their clients, and the IRS, an annual form documenting the year's transactions. The rule comes with a floor to weed out the most casual retailers: The 1099-K is only required when a merchant has at least 200 payment transactions a year totaling more than \$20,000. But it applies to all payment processors, including Paypal, Amazon.com, and others that service very small businesses.

The goal of the new regulations is to catch income that is going unreported to the IRS. The federal government loses an estimated [\\$300 billion each year](#) from the "tax gap" between what individuals and businesses owe and what they actually pay. "Better information reporting helps the tax system work better by ensuring that everyone pays what they owe," IRS Commissioner Doug Shulman [explained last year](#) as his agency unveiled the 1099-K. "The new law gives us an important new tool for closing the tax gap and also provides business taxpayers better documentation to compute and report their income and expenses."

For companies that currently report all their credit card and Paypal sales to the IRS, the 1099-K requirement will have little impact. All the paperwork will be done by the bank or payment processing service, and business owners will simply receive a form at the end of the year listing their total receipts.

The 1099 changes attached to the health care reform bill are another kettle of fish. These massively expand the requirements for filing the "1099-Misc" form, which companies use for recording payments to freelance workers and other individual service providers. Until now, payments to corporations have been exempt from 1099 rules, as have payments for the purchase of goods.

Starting in 2012, that changes. All business payments or purchases that exceed \$600 in a calendar year will need to be accompanied by a 1099 filing. That means obtaining the taxpayer ID number of the individual or corporation you're making the payment to -- even if it's a

giant retailer like Staples or Best Buy -- at the time of the transaction, or else facing IRS penalties.

In essence, the 1099-Misc is having its role changed from a form for tracking off-payroll employment to one that must accompany virtually any sizeable business transaction. "Just with business travel it would include hotels, rental cars," Henschke says. "Phone service: 1099. Computer service: 1099. Whoever does your postage meter: 1099. You do a little advertising, Yellow Pages: 1099. Your landlord: 1099. You might as well just keep them in your pocket and hand them out as you go around every day."

How did this sweeping provision end up hidden in the health reform bill? No one is willing to take credit for introducing the new legislation, which appeared in the Senate Finance Committee's version of the health bill last fall. Committee chairs Max Baucus, D-Mont., and Chuck Grassley, R-Iowa, both referred calls to committee staffers, who wouldn't comment on the record.

But the provision appears to be a long-in-the-works change that was waiting for the right moment to be attached to legislation. Back in 2007, the Senate 1099 paper trails for income could provide up to **\$345 billion annually** in new federal tax revenues.

Enter the health reform bill. Last fall, as the debate raged over its projected cost, Congressional supporters of the bill began a desperate search for "revenue enhancers" to bring the net cost down -- and eliminating the 1099 exceptions for corporations and goods was seen as an easy way to bring in more cash without raising tax rates. House and Senate staffers "essentially have a cupboard full of convenient revenue raisers that they can put into bills when they need it," notes Chris Edwards, director of tax policy studies for the libertarian Cato Institute. In the case of the 1099 changes, he says, "this was sitting

around, the IRS wanted it and had testified in favor of it, and they needed a revenue raiser. This was just a convenient thing."

Still, the form the new law took was surprising -- especially the requirement that businesses file 1099s when they purchase goods, which hardly anyone saw coming. Henschke's group had previously surveyed its members and learned that they average 10 filings a year of 1099 forms, each of which takes about half an hour to prepare. That's in line with the GAO report, which found that a typical small business spent between three and five hours per year filing 1099s.

But SMC's survey found that extending 1099s just to services purchased from corporations would push that number to at least 200 filings per year for a typical small business -- adding an estimated \$6,000 to the cost of preparing the average tax return. And that's without even accounting for the requirement that 1099s be filed for purchases of goods, a provision that Henschke's group didn't see coming when it conducted its survey last year. "These folks are doing their paperwork in the evenings and on the weekends already," he says. "This certainly adds to the burden substantially."

The IRS has a [draft version](#) of the 1099-K form available now for public feedback, and will begin requiring the form's use next year. The additional 1099 requirements take effect in 2012. The agency is in the process of drafting its guidance on them.

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Reminder: Property owners have until June 30th to appeal their property values if they have missed the deadline last year. You need to go to your local property assessment office and file the appeal as most property owners will not get an assessment notice.