For questions, comments, suggestions or further information, please contact the Department of Revenue at: taxreform@state.mt.us

Governor's Income Tax Advisory Council

May 30, 2002

MINUTES

Attendees:

Senator Bob DePratu
Representative Trudi Schmidt
Kurt Alme
Doug Young
Representative Karl Waitschies
Jon Marchi
Jerry Driscoll
Scott Mendenhall
Chase Hibbard
Senator Jon Tester
Tim Bartz
Karen Olson Beenken (phone)
Leo Berry

Excused: Lary Johnson

Department of Revenue Staff Present

Judy Paynter, Tax Policy & Research Process Lead
Brad Simshaw and Larry Finch, Principal Tax Policy Analysts
Shane Byrne, Tax Policy Analyst
Kyanne Kelly, Administrative Assistant

Information:

The information base is the material prepared for the Council. The only handouts referred to are those given in addition to the basic Council materials.

Chairman Bob DePratu opened the meeting and the Council members introduced themselves. Then Chairman DePratu introduced Governor Judy Martz.

Governor Judy Martz said this tax plan is a beginning to turn this state around. She said this council would be studying a proposal to reduce the Montana income tax by 10%. She said that the council is asked to assure that the plan will benefit Montana taxpayers at all income levels. She also said that this plan reduces the top marginal rates and reduces the effective capital gains rate. She noted that to accomplish this the council would need to explore eliminating federal deductibility. She stated that the plan recommended by the council will be presented to the 2003 legislature and is to promote economic development in Montana. She asked the council to develop a recommendation by the end of August in order to have extensive public comment before the legislature meets.

Chairman Bob DePratu said that the charge of the Income Tax Advisory Council is to reduce the amount of tax that people pay, not just move the numbers around.

Dave Gibson, Director of the Governor's Office of Economic Opportunity, commented on the Imperative for Change. He said that 30 years ago service and retail jobs were 38% of our economy's jobs, and now they are 54% of our jobs. Those jobs, on average pay $18,000 a year. There has been an increase in the number of lower paying jobs and a decrease in the number of higher paying jobs over the last 30 years. That has driven down the median income ranking and the average income ranking from approximately the mid to low 30's when compared to other states to down around the 48th to 50th ranking that it is now. So, we are currently at the very bottom of the income rankings.

He talked about how we can change that. He said that in a global economy high paying jobs of the future are in the knowledge-based economy. He also said that if you have knowledge-based jobs that utilize technology, you then have more highly skilled people in the job market and you get higher wages. He pointed out that if you don't have more knowledge-based jobs, then you continue to see job wages and earnings decline, and earnings and wages will continue to decline until we are dead last in every category.

He stated that there are two things that will improve the economy in a knowledge-based economy, one is increasing worker skill levels and the second is increasing use of technology. He said that without those two components in any industry, not just the high tech market, we will not see change in the median income of the average worker, or it will continue to decline.

He quoted, "In evolution, it is not the strongest and it is not the fastest that survive, it's the most adaptable." He further stated that we have to adapt to the changing world or we are going to get left behind as we have in the last 30 years.

He pointed out that anything we do that is a disincentive to capital is going to hamstring us from turning our economy around. He said that right we now have about a 30% surcharge on capital gains income in this state. He said that we penalize people for generating income and investing in their businesses beyond just taking a wage or a salary. He stated that Montana will not attract high technology business if it does not encourage investment. He pointed out that another problem is attracting highly skilled people. In looking at creating a better economic environment, higher skills equal higher paying jobs. He said this is true of every industry.

Another problem he sees it is that as worker skills increase, mobility increases. He thinks we need a competitive tax structure to retain people who come here to work.

He stated that we have a high marginal income tax rate and it is really hurting us. It is a flat-out flag that we show up as the highest marginal rate. It conveys an attitude of "anti- success". Second, is the issue of perception. He pointed out that from a marketing standpoint, people have options and the perception of an 11% marginal rate creates a bad impression. This penalty works against us. The third issue is how our average effective rate punishes businesses.

He stated that this council was asked to do three things. Reduce the income tax rate by 10%, reduce the top marginal income tax rate, and reduce the tax on capital gains to encourage investment in this state.

He stated that people leave Montana because we don't have jobs. He said we need to create more high paying jobs. Then he said the reason why people don't come back into the state is that they don't make as much money here. He stated that taxes are not the only thing. He asserted that there is a need to start to move the tax structure to encourage businesses to come into the state and begin to turn the economy around.

Chairman Bob DePratu reiterated the goal of the council as being a tax cut for Montanans and revenue neutral for local government.

Larry Finch said the Department of Revenue had spent a year looking at Montana tax structure, examining what is good and what is bad in comparison to other states. The information in the binder shows some of the findings of that study.

Brad Simshaw talked about the effective property tax rate (attachment #1).

Larry Finch said that two things are evident from Brad Simshaw's report: we are not out of line in our income tax in Montana based on comparison with other states and it is very complicated to come up with an effective rate.

Larry Finch talked about corporate income tax. It ranks fourth among the seven western states listed on the table who have a corporate income tax. Nevada, South Dakota and Wyoming do not have a corporate income tax.

He stated that Montana's top marginal individual income tax rate is the highest rate in the country and that alone puts people off right away when thinking of moving a business here. He said that Montana allows people to deduct in full their federal taxes and that there are only a few states that allow this. He said that the disparity between Montana and other states decreases when you look at the effective rate. However, that doesn't matter when the top marginal rate is published in the magazines without further describing how the top marginal rate is not the effective rate when you take federal deductibility into account.

Larry Finch said that Montana's individual income tax ranks about 4th among 8 western states when using relatively low incomes, but as incomes rise Montana's rank becomes higher and higher, going up to first place.

Greg Gianforte, a taxpayer from Bozeman and CEO of RightNow Technologies, a software company employing 200 people testified (attachment #2). He said that capital gains income tends to be lumpy and that the way capital gains is currently structured in this state, it is beneficial to move out of state just when you are about to sell for capital gains. He said that when capital gains are taxed like regular income, it is essentially creating an incentive to leave the state when someone comes into a capital gains situation. He stated that the second difficulty is in recruiting top executives to live in Montana. He said they want to live in a state like Texas where there is no income tax. He said his company set up an office in Dallas because they required world-class talent and couldn't get them to move into the state. He stated that in the long term that doesn't bode well for us in the competitive world market. He pointed out that we are not competing with the regional eight states but we are part of a world market and competing with people from around the world. He presented three particular solutions: If we want to create high tech jobs, the best solution would be to replace the current income tax with a sales tax. He proposed we eliminate federal deductibility, thus lowering the marginal tax rate. He said perception is reality; it doesn't matter what reality is, it is about what people perceive reality to be. When he is trying to recruit people for his company, they find 11% to be an offensive tax rate.

He said we need to do something about capital gains. He stated that we have an incentive right now with the current tax structure to encourage our successful employers and knowledge workers to leave the state if they ever are able to convert some of the wealth they've created into real value.

He suggested looking at the tourism and resort tax to make up the difference created by these tax cuts.

Mr. Gianforte said that if we want the state to be receptive to high tech, the council might want to consider some kind of targeted capital gains incentive for businesses that are started to create high-wage jobs. He said the state would benefit because the wages are all getting paid in the state and you still would get the income. He talked of a targeted program that would create a "high tech haven" in Montana that the Governor and the Administration could wave very highly on a national level to say, "come start a business in Montana." He stated that there is not a lot of income coming from capital gains in the state right now, so it would not have a negative revenue impact but could potentially be the solution to change the perception, which is the reality.

Ernie Dutton, a taxpayer, testified for reducing Montana's high marginal tax rate and capital gains rate. He said the majority of his clients are well informed about taxes and more aggressive in their tax planning. He stated that many long-time businessmen now claim primary residence outside of Montana. He said that when people move out of the state because of taxes there is a loss of investment capital to create jobs as well as income tax. He stated that perception is everything; if people believe that Montana's income tax is the highest in the United States, rightly or wrongly, they base their decisions on that. He said that many people vote with their feet and move out of state rather than attempt to change the situation through the political process.

Larry Finch presented information on the income tax rate. He said that the effective tax rate is simply your total tax liability divided by your total income. He stated that marginal rates are what percentage of the next dollar you earn that you pay in tax. The marginal rates represent your combined federal/state marginal tax rate that you would pay above a state like Wyoming that has no income tax.

Kurt Alme said federal deductibility works against us. He said that as federal tax policy pushed capital gains rates down, it pushed our rate of capital gains up and that now we have an effective marginal rate on capital gains about 30% higher than we do on ordinary income.

Larry Finch showed a comparison of income tax rates with Montana and the other states in Rocky mountain region.

Larry Finch discussed the Bloomberg Personal Finance Magazine article. He said Bloomberg ranks good places to live and bad places to live with respect to taxes. Montana received the only "F."

Dave Gibson showed how published articles give incomplete information on Montana's income tax and create a perception of Montana having high income tax. He discussed articles in the book titled, "Montana Individual Income Tax Perceptions and Problems" compiled by the Department of Revenue. Doug Young pointed out that in reality, not just perception, we have a very high income tax rate.

Larry Finch presented information on federal deductibility, how it works now, and how it would change with different scenarios.

Tim Bartz stated that there are only 4-5 states that have federal deductibility. He said that if perception is an important factor, then we have to do something about federal deductibility. Chairman Bob DePratu agreed that it is an issue, especially for people in the higher incomes that we are trying to attract.

Scott Mendenhall asked if this committee was to come to consensus. Chairman Bob DePratu said the committee had to stay within the parameters of the charge given by the Governor and work toward consensus within those parameters. Chairman Bob DePratu said that the charge given to this committee is to find something that would give Montana a 10% income tax cut, possibly eliminate federal deductibility and reduce the tax on capital gains.

Kurt Alme said the committee's purpose is to do four things and within those parameters he would hope the committee would operate by consensus. Chase Hibbard asked what the options would be if consensus didn't work. Chairman DePratu said the council would try to do consensus, but we may need to have votes on specific decisions and the final recommendations.

Tim Bartz asked if this committee would focus on corporate tax. Kurt Alme said no, only individual income tax.

Representative Trudi Schmidt asked if the committee would be making recommendations and then the bill carried by somebody to the legislature. Chairman DePratu said yes. Kurt Alme said that this committee is to advise the Governor.

Kurt Alme said the umbrella we are working under is a 10% reduction in tax that benefits every level of taxpayer.

Doug Young pointed out that eliminating the perception of Montana as a high income tax state was not in the charge. Kurt Alme said that it is not in the charge, but reducing top marginal rates is the charge. Chairman DePratu said that in doing that it would help the perception.

Scott Mendenhall pointed out that a 10% cut does not mean that every taxpayer would have a 10% cut, but that in the aggragate there would be a 10% cut.

Karl Waitschies asked if the charge was to provide for the 10% reduction, regardless of what the Tourist Tax Council does. Chairman DePratu said that both councils have to come to a 10% reduction so that it is revenue neutral.

Senator Tester asked if the tax cut and tourist tax would be implemented simultaneously. Judy Paynter said that would be desirable to ensure revenue neutrality.

Leo Berry said the charge is specific, but does not talk about the underlying goals that the council is trying to accomplish. He said we presume that one is perception. He then asked if one of the goals is to attract high tech business, or other business. Chairman DePratu said the council should work out its goals.

Kurt Alme said he thought there was flexibility in picking the goals. He stated that one of the major focal points is economic development, that is, looking at what can be done to create and retain good paying jobs. He said that is explicit in the change imperative discussion, but implicit in the council charge. He said other goals can be considered also, whether that is fairness, equity, administrative ease, etc. All the other goals that any good tax system has could be brought to bear on this.

Leo Berry said we should be comparing to Washington, Oregon or California rather than South Dakota, and the regional states around us. He said that if we are looking at the $52,000 year jobs, he would rather look at these states for comparison. Chairman Bob DePratu pointed out that there are a lot of industries other than just high tech that can create high paying jobs.

Kurt Alme said the Dakotas were added primarily because of the eastern Montana economy. He said there would be different economic development needs for different parts of the state.

Chase Hibbard said good tax policy is one where one area does not stand out from other areas. He said we have a high reliance on one tax base, but that good sound tax policy is to broaden the burden, like the three-legged stool, for a more balanced tax structure.

Larry Finch reviewed from the handouts some of the various options. The options illustrate for discussion the various types of approaches that have been looked at or could be looked at as ways to achieve the goals of the committees charge.

The council discussed each of the options.

Karl Waitschies said that in order to meet the charge, federal deductibility would have to be discussed and where to go from there.

General feeling was just to move on from Option 1.

HB 428 was discussed. Kurt Alme said this is an alternative to look at if we don't want to look at the federal deductibility route. He said that the key issue is if we want to get rid of federal deductibility, and that had to be tackled head on. He stated that if we are not going to get rid of federal deductibility, something like HB 428 may be an option or the next one, the 10% cut. He said that without dealing with federal deductibility, the council would have to look at some form of the first three options.

Jon Marchi said he thinks the elimination of federal deductibility is paramount to the whole process for two reasons, the first being the perception issue. He said that the only way to deal with the perception issue would be to do away with federal deductibility. His other point was that there are only 4-5 states that allow federal deductibility now and it doesn't make any sense for Montana to be one of those states.

Jerry Driscoll suggested that for each year you have owned the property or business for which you are receiving capital gains, you would get 2% off the top for each year you've owned it. He said this would reward businesses that stay in business in Montana. He doesn't want to eliminate 100% of federal deductibility. He suggested the committee pick a number, and then deduct the first $10,000 or something like that.

Tim Bartz said this would be a problem from a practical standpoint. Actually knowing how long someone's holding period on a business would be difficult to determine. Just from a simplicity standpoint, it would be better to go with a rate reduction of some sort rather than tying it to number of years. He said that if you pass something as an estate it has a different holding period than if you pass it as a gift. He stated that it is difficult with ranches to determine how long someone has owned it; it is not like buying bonds.

Larry Finch said that reducing the top rate would reduce the marginal rate of tax on capital gains and make it more competitive with other states.

Kurt Alme asked, "What do we want our capital gains rate to be? Do we want it to be the same as ordinary income? Do we want it to be lower? Are we comfortable with it being above ordinary income?" He stated that if the council wanted it to be above ordinary income, than they could just cut rates and both capital gains and ordinary income would come down together. He said if the council wanted to line them up together they could either get rid of federal deductibility or do some special capital gains cut, which would approximately line it up. He stated that if the council wanted to give capital gains preferential treatment like at the federal level, they would have to either do federal deductibility and the capital gains cut, or just a big capital gain cut, to move it down to ordinary income. He suggested that a good discussion to have at some point would be where do we want capital gains to land? Do we want it to be at or below ordinary income?

Chairman Bob DePratu said that now we are at zero because people move out of state when they sell something with a big capital gain. He stated that we need to reach a top level somewhere in the middle of the road that would encourage people who are in the position of selling to find it worth staying in the state.

Jon Marchi said his preference would be to treat capital gains essentially the way the federal government treats it, that is, it gets preferential treatment. He said that the only way to grow the economy is people investing back in the economy. He said he wants people to be willing to take the profits from a previous investment, because the taxes are not onerous, and reinvest the money in Montana. He said that if we could tie the formula in Montana to what the federal government is doing, we would be well off.

Tim Bartz said you need to start where you want to be at with ordinary income to know where you want to be with capital gains. Montana's corporate tax rate falls in the middle, 6.75% of every dollar. If we had the top individual tax rate at this rate, then beyond that the capital gains rates at 5%, it would get us into the ball park where people would really be looking at whether it worth leaving the state to before taking their capital gains. He stated that 5% would be a reasonable target. If your marginal bracket is less than 5%, then you just pay what ever your marginal bracket is. He said that if it is above 5%, then the capital gains rate on a long term capital gain would be capped at 5%.

Representative Trudi Schmidt said the goals or bottom line needs to be common sense, working together, being principled, and fair.

Chairman Bob DePratu said that right now we are losing a lot of people from out of state so we do need to make some kind of a change, but what is a fair top level.

Judy Paynter said that if you could remove federal deductibility, adjust your brackets and your rates, and get your rate down to 6.9 or below 7, you will automatically have at least a 25% drop on your capital gains just in doing that. She stated that when you get your rate down below 7, you have to look at your real capital gains rate. She said it is necessary to understand how much it reduces the capital gains rate when you reduce that top rate from 11 to say 7 or lower. You get a tremendous change on the tax rate on capital gains when you do that.

Senator Jon Tester stated that he would like to see where the 7% income tax cut would put the capital gains rate. He stated that it would be nice to keep it as simple as possible and in that way attach it to the federal plan.

Kurt Alme suggested we move away from HB 428, and look at the third option. He said the first two plans do not allow taxpayers at lower income levels to benefit from the cut.

Scott Mendenhall wanted to hear why federal deductibility would not be something everyone would want.

Kurt Alme said the proposal is that you eliminate federal deductibility but you reduce rates and spread brackets to compensate for the $135 million expenditure you just freed up, then you do the 10% tax reduction. He stated that it is a two-step reduction with federal deductibility. He said he thought a major perception problem with the plan is that people think a $80 million tax increase is buried in the tax plan by eliminating federal deductibility and then only giving a 10% cut. However, he said that when you eliminate federal deductibility, drop rates to off set for the additional tax revenue, and then do a 10% cut, you are still going to have people who will pay more taxes. He said there are two types of groups for whom this is true. He stated that first of all there is going to be a timing issue, people who in the particular year we are talking about have a real heavy year of federal taxes paid, it's a timing issue for them, not a chronic issue. He said that there is a second group, the chronic losers, the people who will lose year after year and these are people who have a significant federal liability and a lower state liability because our tax systems are not identical. He used the example that if you invest in federal bonds the federal bonds interest is taxed at the federal level but not taxed at the state level. In this example, you pay some significant federal income tax and you take the big federal deductibility against the income which is taxed in Montana that does not include those federal bonds. He said this example applies to a small group of people.

Larry Finch went through the federal deductibility handout. He said that people who were losers one year were not necessarily losers the next year. Larry talked about SB 173. He said SB 173 does not meet the charge of providing cuts for all levels of taxpayers as it was proposed, but that as proposed it did not contain a $66 million tax reduction.

Chairman DePratu suggested running the numbers on 6.75% and 6.9%, capping the capital gains tax at 5% both with the 6.75% and 6.9% rate.

Representative Trudi Schmidt said the question is should capital gains be taxed different from other income. Chairman Bob DePratu said it would be easier to discuss with actual numbers to compare.

Doug Young suggested excluding a certain percent of capital gains from taxation and that would have a somewhat different effect. He stated that we are trying to concentrate these effects at the top income levels. Tim Bartz said we are not concentrating at the top. He said that it seems like the middle class people don't benefit as much as the upper and lower class.

Chairman Bob DePratu suggested looking at plans that keep federal deductibility.

Senator Jon Tester suggested that we eliminate federal deductibility, cut taxes by 10% and then include an exclusion for capital gains.

Chairman Bob DePratu suggested they run numbers on Option 3, including a 10% cut across the board without eliminating federal deductibility.

Kurt Alme suggested running a report on the 30% exclusion of capital gains and find out how much that costs, then take the rest of the money to get a 10% cut and drive the rates down something less than 10%.

Doug Young pointed out that if you spend all your money on capital gains, you are still going to have the perception problem. He suggested we should decide if we want to get rid of perception or not. He also suggested that rather than having a lower rate on capital gains, to look at an exclusion for capital gains.

Leo Berry summarized where the committee was at this point. He stated that they are looking at eliminating federal deductibility with two additional options, one is reducing capital gains to 5%, and the alternative option is eliminating 30 % of the capital gains.

Chairman Bob DePratu clarified that the council would be looking at those options with a 6.9% and 6.75% top rate on ordinary income.

Leo Berry said he thinks that perception is important. He favors getting rid of federal deductibility and getting the top marginal rate down as far as possible, because it impacts people's decision to move to Montana.

Leo Berry asked at what level of capital gains tax do people start to seriously consider moving out of Montana. Tim Bartz said, usually when the numbers creep over $50,000 it seems to start getting their attention. Kurt Alme pointed out that there were letters in the blue book where people talked about these numbers.

Jerry Driscoll suggested putting a cap on federal deductibility rather than eliminating it. Deduct 100%, not to exceed $10,000. He said that in effect you raise taxes for the higher income people by eliminating deductibility. Larry Finch said there are some scenarios where taxes would be raised. Kurt Alme said capping it at $10,000 wouldn't likely impact most taxpayers. We should look at some lower caps, such as $3,000.

Kurt Alme said it comes down to numbers. Federal deductibility disproportionately benefits high-income people, so that's most likely where losers are going to show up. He said there will be losers in any plan. He stated that the thing that makes it difficult to actually pass a tax plan is if the losers fall into an identifiable class.

Tim Bartz said if you go only part way in eliminating federal deductibility, you are asking for problems.

The council settled on having the following information prepared for the next meeting.

1. Include Washington, California and Oregon in the effective and marginal tax rate comparisons
2. Provide the change in marginal capital gains rate (and our competitive stance) when the top stated marginal tax rate is 6.9%, 6.75%
3. Analysis eliminating FITD and reducing the top rate to 6.75%
4. Do analyses of eliminating FITD, with:
    a. top rate of 6.9% and top capital gains rate of 5%
    b. top rate of 6.9% and 30% capital gains exclusion
    c. top rate of 6.75% and top capital gains rate of 5%
    d. top rate of 6.75% and 30% capital gains exclusion
5. For all analyses done: 1) bring the tax rate tables used and 2) bring the distribution of winners and losers by income bracket and by size of change
6. Information on capital gains:
    a. distribution, by income level
    b. revenue raised, by income level
    c. impacts of optional maximum marginal rates
    d. impacts of alternative exclusion percentages
7. Impact of 10% across the board reduction, including a 30% capital gains exclusion, without eliminating FITD
8. Cap on FITD at $3,000 – like Oregon

The committee set the next meeting for June 20, 2002 and the meeting was adjourned.