



Policy Basics: Individual Income Taxes in Montana

December 2020

Introduction to Individual Income Taxes in Montana

For generations, our tax dollars have served as shared investments in the programs and services that make our state a great place to live, work, and play. Tax dollars enable Montanans to work together for those things which we could not achieve alone, like educating our children, building infrastructure, keeping our air and water clean, and paving the way to a strong economy for everyone.

In Montana, these shared investments are managed through the state's General Fund. Taxes make up the vast majority of the revenue for the General Fund, and the individual income tax is the single largest source of revenue, comprising nearly 60 percent of the state's General Fund revenue.¹

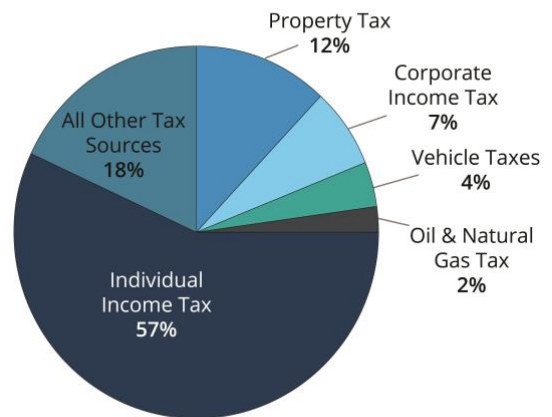
Wages and salaries make up almost two-thirds of income subject to individual income tax.² In general, taxes paid by corporations are paid through the corporate income tax. However, depending on how the entity is structured, business income may be reported through the individual income tax.

Specifically, if the business is structured as a C-corporation in order to receive the legal benefits associated with such a status, its taxes would be classified as corporate income taxes. All other businesses, including sole proprietorships, partnerships, limited liability corporations, and S-corporations, report income on individual returns, and this amount is reflected in both pass-through income and business income, which comprises less than 13 percent of total individual income.³

Past Income Tax Cuts Hurt More than Helped

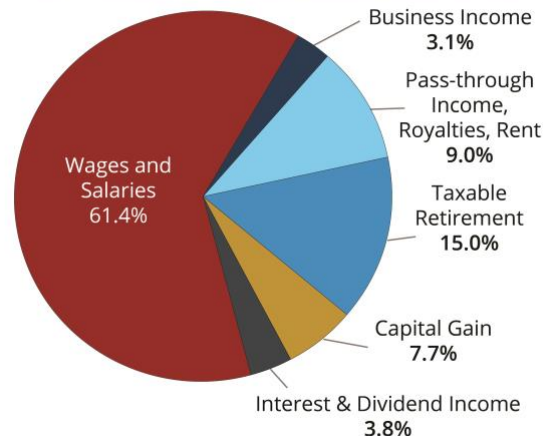
In 2003, the Montana Legislature made harmful changes to our income tax system. That year, legislators passed a bill that greatly altered Montana's tax system by providing a significant tax cut for the wealthiest households.⁴ The changes made in 2003 included collapsing the income tax brackets and creating a tax cut for capital gains income. Both of these provisions make our tax system more **regressive**, giving a greater

Most of the General Fund Comes from Individual Income Tax



FY 2020 General Fund Revenues (total \$2,533 million)

Wages and Salaries Make Up Two-Thirds of All Individual Income Tax



Income reported on full year residents tax returns

tax cut to high-income households and costing the state nearly a billion dollars in revenue in the decade from 2005 to 2016, which could have been used to invest in our future.⁵

Prior to the tax cuts implemented in 2003, Montana had 10 different income brackets, with each higher income bracket paying a slightly larger share of their income in taxes.⁶ In the former structure, the lowest income bracket paid 2 percent of their income in taxes, while the highest bracket (applying to incomes greater than \$108,700, adjusted for 2019) paid 11 percent of that income in taxes.

The changes in 2003 reduced the total number of income brackets to seven. In 2019, the top bracket now includes all households making more than \$18,400.⁷ That means someone earning just above the minimum wage now faces the same top marginal tax rate as someone making \$1 million. As a result of the 2003 tax cuts, the wealthiest households experienced the greatest tax reductions. Almost half (47.6 percent) of the reduction in income taxes went to households with incomes of more than \$500,000, the top 0.4 percent of taxpayers, whose average tax reduction was \$30,499. For the bottom 81 percent of Montana taxpayers, the average tax cut was just \$23.⁸

Key Terms

Progressive refers to a tax or a tax system in which households with higher incomes pay a larger portion of their incomes in taxes compared to those households with lower incomes.

Regressive refers to a tax or tax system in which households with lower incomes pay a larger portion of their income in taxes compared to those households with higher incomes.

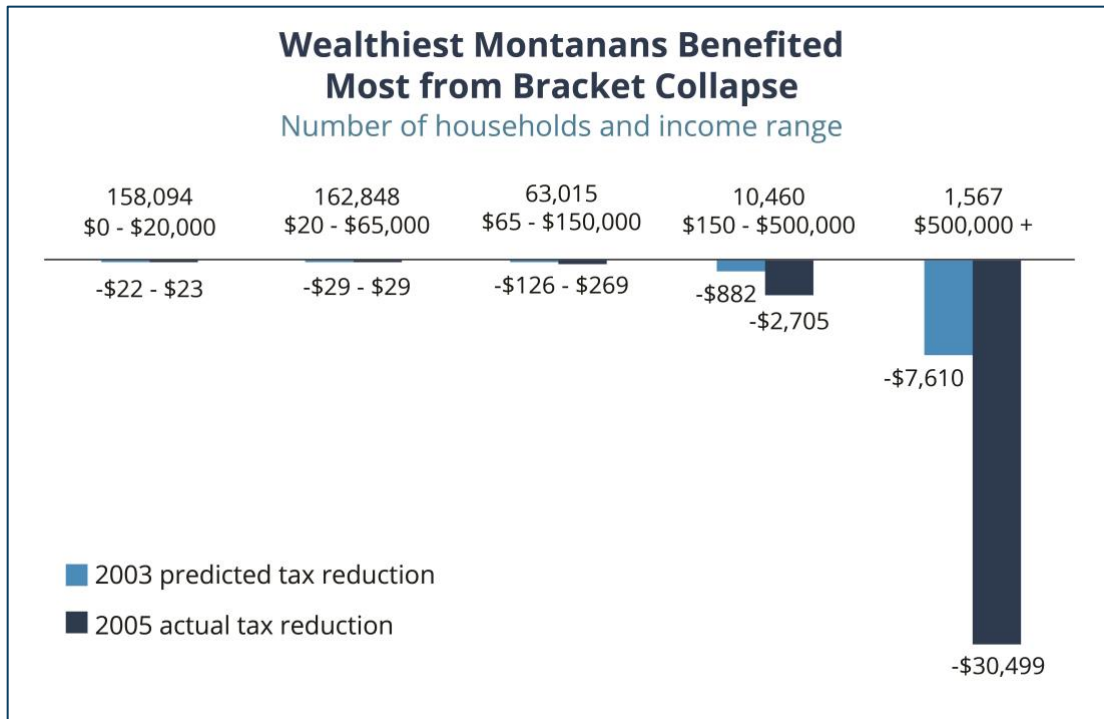
Millionaires Pay the Same Top Tax Rate as Those Making Minimum Wage

Effects of 2003 Tax Changes on Income Tax Brackets and Rates

Before Bracket Collapse		After Bracket Collapse	
Taxable Income	Marginal Tax Rate	Taxable Income	Marginal Tax Rate
\$0 to \$3,100	2.0%	\$0 to \$3,100	1.0%
\$3,100 to \$6,200	3.0%	\$3,100 to \$5,400	2.0%
\$6,200 to \$12,500	4.0%	\$5,400 to \$8,200	3.0%
\$12,500 to \$18,700	5.0%	\$8,200 to \$11,100	4.0%
\$18,700 to \$24,900	6.0%	\$11,100 to \$14,300	5.0%
\$24,900 to \$31,000	7.0%	\$14,300 to \$18,400	6.0%
\$31,000 to \$43,400	8.0%	\$18,400 +	6.9%
\$43,400 to \$62,100	9.0%		
\$62,100 to \$108,700	10.0%		
\$108,700 +	11.0%		

Brackets Adjusted for Inflation to 2019

As a whole, these tax cuts have created a more regressive income tax structure. In fact, while our individual income tax remains slightly progressive, it is not progressive enough to offset the regressivity of our property taxes and selective sales and excise taxes.⁹ In other words, **when looking at the entire tax system in Montana, taxpayers with lower wages pay a larger portion of their income in taxes compared to those with higher incomes.**



The changes have also had a negative impact on Montana’s revenue. In the first decade following the 2003 tax cuts, it is estimated that the state *lost one billion dollars* in revenue.¹⁰ This lost revenue could have been used to educate our children, keep our communities safe, and protect our land and water, instead of cutting taxes for those who need it the least.

For further information about the income tax bracket collapse, see Montana Budget & Policy Center’s report, [The Montana We Could Be: Tax cuts, aimed at the rich, take a toll.](#)

Capital Gains Tax Credit Favors Wealth Over Work

Currently, Montana is one of only nine states that offer significant tax breaks for capital gains.¹¹ The capital gains credit has proven to be unaffordable, is unfair to Montanans who earn income through wages, and has not benefited the Montana economy.¹²

The capital gains credit lowers the effective tax rate for people who earn income through investments compared to those who earn income from wages. This creates a tax system that favors wealth over work. In 2018, more than half of the benefits from the credit went to the wealthiest one percent of taxpayers (just 4,713 households in Montana).¹³

Key Terms

Capital Gains are income from the sale of assets, such as stocks, bonds, vacation homes, art, or businesses. Capital gains income is only “realized” when the asset is sold for a profit. As long as the investor continues to own the asset, any increase in value is not considered income. The first \$500,000 in capital gains from primary residences is not taxed. Likewise, profits from the sale of an individual retirement account are not treated as capital gains.

Nearly all Montanans who earn lower and middle incomes do not benefit from the credit because they are much more likely to earn their income on the job rather than through the sale of large assets. In 2017, more than 78 percent of Montana taxpayers – more than 448,000 taxpayers – did not receive any benefit from the capital gains credit.¹⁴ In fact, the assets owned by most Montanans – primary residences and retirement funds – are not treated as capital gains income when they are sold.

Treating capital gains more favorably than wages will not help the economy. In fact, the lost tax revenue could actually prevent growth by forcing state budget cuts. The capital gains credit cost Montana more than \$55 million in 2018.¹⁵ These vital dollars could have been used to fund growth-oriented services like education, health care, and infrastructure improvements.

For more information, see MBPC's report, [Capital Gains Tax Credit: Valuing Wealth Over Work in Montana](#).

Earned Income Tax Credit Makes Work Pay

In 2017, the Montana Legislature passed a state earned income tax credit (EITC) making Montana the 29th state to create a state EITC to help working families make ends meet.¹⁶ Beginning in 2019, Montana started providing a refundable tax credit set at 3 percent of the federal EITC to households working at lower wage jobs, offering a maximum benefit of \$192. In tax year 2019, 71,473 Montana households received the EITC.¹⁷

Prior to the 2017 session, Montana required families living on poverty-level incomes to pay more in income taxes than almost all other states.¹⁸ A state EITC is an effective tool to help people rise above poverty-level incomes by putting more money in the pockets of families to spend on groceries or catch up on bills. However, Montana can do more to improve the economic security of families living on low incomes by increasing the credit amount. Among the 29 states and District of Columbia that offer a state EITC, Montana's 3 percent credit is the lowest.¹⁹ Raising the value of the credit to 10 percent of the federal credit, similar to Colorado and Nebraska, would result in a maximum benefit of \$666, and will go further in helping families meet their basic needs.²⁰

For more information, see MBPC's report, [A State Earned Income Tax Credit: Helping Montana's Families and Economy](#).

Deduction for Federal Taxes Paid

Montana is one of just six states that still has a deduction for federal income taxes paid, a deduction that disproportionately benefits the highest income earners in the state and costs the state much-needed revenue.²¹ In 2017, this deduction cost \$94.2 million.²²

The deduction for federal taxes paid is an unusual tax break that allows taxpayers to deduct the federal taxes they pay from their Montana taxable income. The deduction is only available to those who utilize itemized deductions and is capped at \$5,000 for a single taxpayer and \$10,000 for married taxpayers filing a joint return.²³

Eliminating this deduction would impact a little more than one-third of taxpayers overall, with more than two-thirds of the tax increase going to the top 20 percent of taxpayers. Halving the deduction from \$5,000 to \$2,500 per spouse would generate \$27 million in revenue for the state.²⁴

Income Taxes in Indian Country

Generally, all individual tribal citizens are subject to federal income taxes. The exception to this is income derived directly from allotted trust lands or treaty fishing rights.²⁵ In Montana, tribal citizens are also subject to state income taxes if they live or work off the reservation where they are enrolled.²⁶ In 2019, 40 percent of American Indians resided off-reservation in Montana, and many more American Indians living on their reservation were working in nearby communities.²⁷

Federally recognized tribal governments do not pay state income taxes because states cannot tax tribal nations in Indian Country.²⁸ Thus, federally recognized tribal nations receive the same income tax exemption as federal and state governments. However, income generated through tribal corporations chartered under state law is subject to federal and state income taxation.²⁹

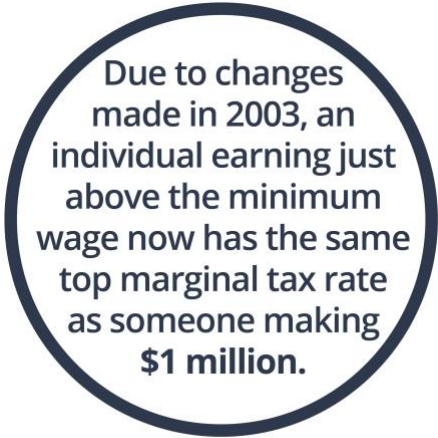
Tribal governments, like federal and state governments, have the right to tax the income of their own citizens, but few, if any, actually do. Each tribal nation has its own reasons stemming from its unique history and cultural views on the matter. Today, infringement upon tribal sovereignty, systemic racism and present-day discrimination play into a system of lower incomes and higher rates of unemployment on many reservations, contributing to the unfeasibility of taxing tribal citizen income. In Montana, 14 to 41 percent of reservation residents live in households with poverty-level incomes.³⁰ Likewise, unemployment on some reservations in the state is as high as 31.1 percent.³¹

For more information, see MBPC's report series [Policy Basics: Taxes in Indian Country Part 1: Individual Tribal Members](#) and [Policy Basics: Taxes in Indian Country Part 2: Tribal Governments](#).

Better Tax Choices for Montana

Our income tax system is one of the primary ways that we pool our resources to make investments in public services and infrastructure that help make our communities stronger, safer, healthier, and more prosperous. Montana can make better choices that do not put the greatest weight on those making the least. The following reforms would greatly strengthen Montana's income tax system:

- Repealing and reducing the capital gains tax credit;
- Restoring a top marginal bracket limited to highest-income households;
- Eliminating the deduction for federal taxes paid; and
- Increasing the value of the state EITC.



Due to changes made in 2003, an individual earning just above the minimum wage now has the same top marginal tax rate as someone making \$1 million.

Montana needs a modern income tax system that makes continued investment in our communities and economy, paving the way for a more prosperous future for our children and grandchildren.

¹ Montana Legislative Fiscal Division, "[2023 Biennium Financial Outlook](#)," Sept. 15, 2020.

² Montana Legislative Fiscal Division, "[Revenue Estimate Recommendations](#)," Nov. 19, 2018.

³ Montana Department of Revenue, "[Biennial Report: July 1, 2016-June 30, 2018](#)," Dec. 2018.

⁴ Montana 58th Legislature, "[Income Tax Reduction with Revenue from Limited Sales Tax](#)," SB 407, enacted on Apr. 30, 2003.

⁵ Institute on Taxation and Economic Policy, "Montana Personal Income Tax Revenue Lost, 2005-2016," Apr. 2016, on file with author. See also Montana Budget & Policy Center, "[The Montana We Could Have Be: Tax cuts, aimed at the rich, take a toll](#)," July 2016.

⁶ These brackets correspond to varying amounts of taxable income. Taxable income is income after deductions and exemptions have been subtracted.

⁷ This figure is adjusted each year for inflation. Montana Department of Revenue, "[2019 Individual Income Tax Rates](#)," Accessed Oct. 7, 2020.

⁸ Montana Department of Revenue, "[The Revenue and Taxpayer Impacts of the Income Tax Provisions of SB 407](#)," Dec. 2006.

⁹ Institute on Taxation and Economic Policy, "[Who Pays? A Distributional Analysis of the Tax Systems in all 50 States, Montana: State and Local Taxes](#)," Oct. 2018.

¹⁰ Montana Budget & Policy Center, "[The Montana We Could Be: Tax cuts, aimed at the rich, take a toll](#)," July 2016.

¹¹ Only nine states provide a broad preferential tax treatment on capital gains. McNichol, E., "[State Taxes on Capital Gains](#)," Center on Budget and Policy Priorities, Dec. 11, 2018.

¹² Montana Budget & Policy Center, "[Reality Check: Tax Cuts Will not Grow the Economy](#)," Mar. 2013.

¹³ Department of Revenue, "Top 1% of Households, Total Income, Tax, and Capital Gains Income," accessed September 2020, data on file with author.

¹⁴ Montana Department of Revenue, "[Biennial Report: July 1, 2016 – June 30, 2018](#)," Dec. 2018.

¹⁵ McNay, A., "Capital Gains Tax Credit Amount," Montana Department of Revenue, Sept. 2020, on file with author.

¹⁶ Montana 65th Legislature, "[Provide for Montana Earned Income Tax Credit](#)," HB 391, enacted on May 11, 2017.

¹⁷ McNay, A., "RE: 2019 EITC filers," Montana Department of Revenue, email to Rose Bender, Nov. 5, 2020, on file with author.

¹⁸ Hartig, S., Skinner, C., and Econo, M., "[Taxing the Poor: State Income Tax Policies Make a Big Difference to Working Families](#)," National Center for Children in Poverty, Nov. 2014.

¹⁹ Williams, E. and Waxman, S., "[States Can Adopt or Expand Earned Income Tax Credits to Build a Stronger Future Economy](#)," Center for Budget and Policy Priorities, Feb. 2018.

²⁰ MBPC calculations using Internal Revenue Service, "[Earned Income Tax Credit Income Limits and Maximum Amounts](#)," Oct. 2020.

²¹ Institute on Taxation and Economic Policy, "[Who Pays? A Distributional Analysis of the Tax Systems in all 50 States, Montana: State and Local Taxes](#)," Oct. 2018.

²² Montana Department of Revenue, "[Biennial Report: July 1, 2016 – June 30, 2018](#)," Dec. 2018.

²³ Montana Department of Revenue, "[Biennial Report: July 1, 2016 – June 30, 2018](#)," Dec. 2018.

²⁴ Institute on Taxation and Economic Policy, 2015, on file with author.

²⁵ U.S. Internal Revenue Service, "[Employment Tax for Indian Tribal Governments](#)," Kim, Y., "[Federal Taxation of Indian Tribes and Members](#)," Congressional Research, Oct. 26, 2007.

²⁶ Bureau of Indian Affairs, "[Frequently Asked Questions](#)."

²⁷ Montana Office of Public Instruction, "[Essential Understandings Regarding Montana Indians](#)," 2019.

²⁸ U.S. Constitution, Article 6, Clause 2; *Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450, 458 (1995); *Oklahoma Tax Commission v. Sac & Fox Nation*, 508 U.S. 114, 126 (1993); *Moe v. Confederated Salish & Kootenai Tribes*, 425 U.S. 463, 475 (1976); *Lummi Indian Tribe v. Whatcom County*, 5 F.3d 1355, 1357 (9th Cir. 1993); *Standing Rock Sioux Tribe v. Janklow*, 103 F. Supp. 2d 1146, 1153-54 (D.S.D. 2000); *Montana v. Blackfeet Tribe*, [471 U.S. 759](#), 764 (1985).

²⁹ U.S. Internal Revenue Service, "[Revenue Ruling 94-16](#)."

³⁰ U.S. Census, 2014-2018 American Community Survey 5-Year Estimates, "[My Tribal Area](#)," for each reservation in Montana.

³¹ U.S. Census, 2014-2018 American Community Survey 5-Year Estimates, "[My Tribal Area](#)," for Fort Belknap Reservation and Off-Reservation Trust Land in Montana.