Montana Department of Revenue

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To: Senate Taxation Committee

From: Dan Dodds, Senior Economist

Date: March 24, 2011

Subject: Information Requested

During the Hearing on SB 398 committee members asked several questions about income growth and the impact of SB 407 (2003) on high-income and low-income taxpayers.

The graph on the first attached page shows the percentage difference in tax liability, by income group, between current income tax rates and the rates that were in effect before SB 407. The blue, red, and green lines show differences calculated for actual returns filed for those years. The purple line shows the differences produced by running the HJ2 forecasting model with current rates and the old rates.

Each year, the percentage difference in tax between current rates and the old rates is largest at low and high incomes and is small for a range of middle incomes.

The graphs on the next two pages show the average dollar differences in tax liability for each income group. The first of these two graphs shows all returns. The second shows returns with income less than $140,000.

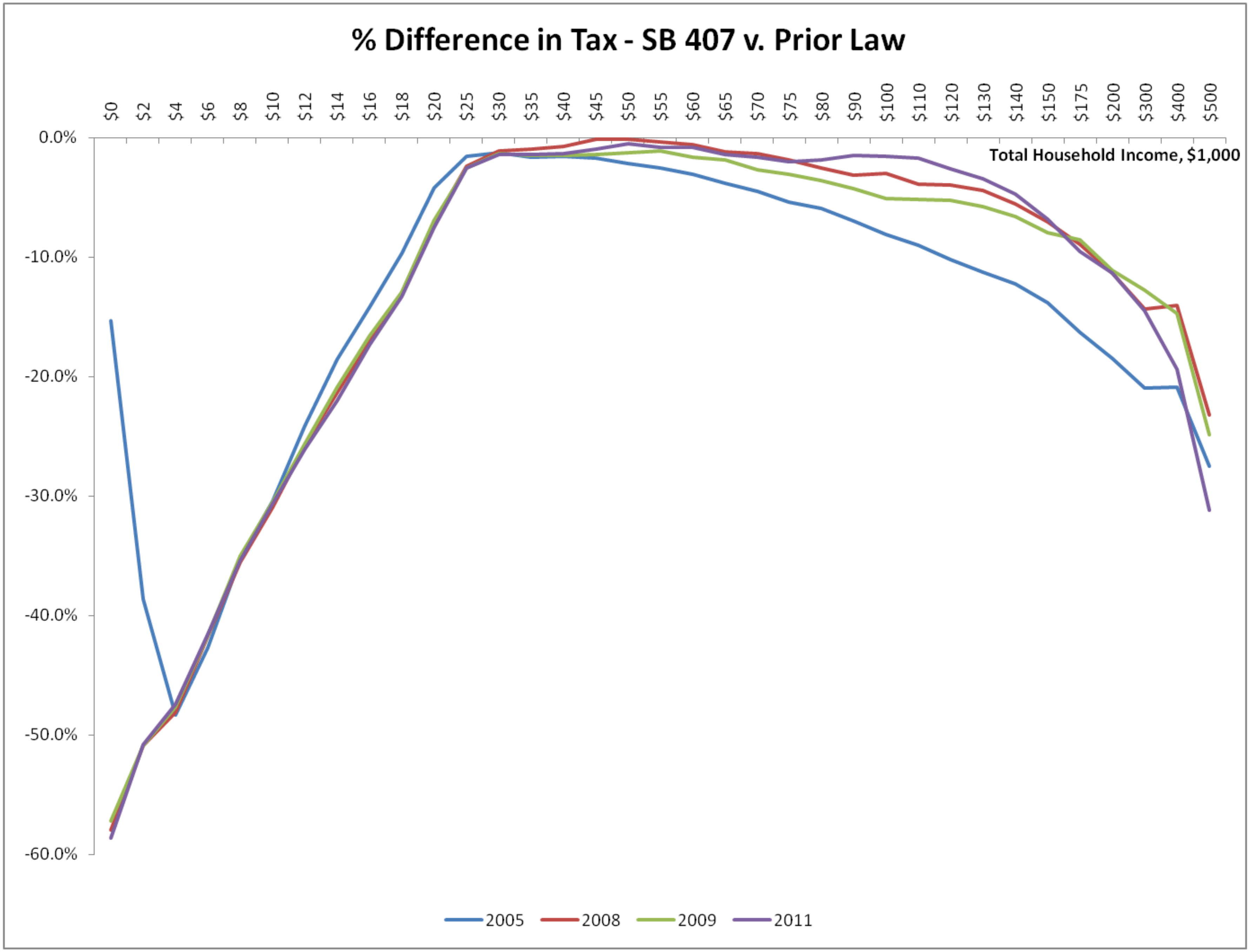
The dollar difference in tax between current rates and the old rates is largest at high incomes. It is smallest in a range beginning at about $25,000 and extending through about $45,000 to $60,000 depending on the year.

The fourth attached page shows total household income reported on returns for 1998 through 2009. In the graph on the top of the page, the height of the bar for each year shows total income reported on all returns. The blue part of each bar shows total income reported on the half of returns with the lowest incomes, the green part shows income reported on the 10% of returns with the highest incomes and the red shows income reported on the remaining 40% of returns.

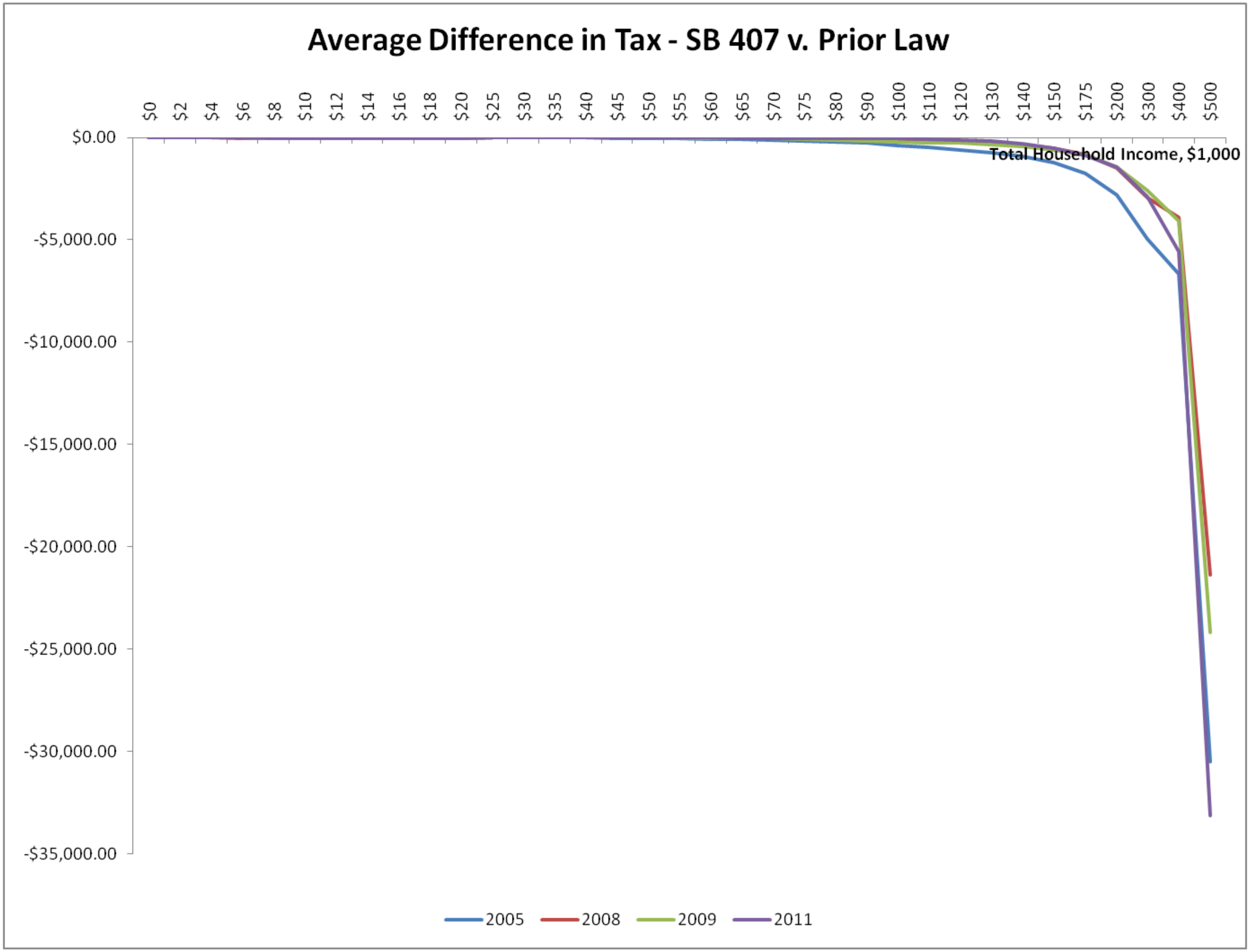
The table on the bottom of the page shows the percent of total income reported by each income group and total income reported on all returns. Total income grew from 1998 to 2000, was relatively flat in 2001 and 2002, grew again from 2003 through 2007, and then fell in 2008 and 2009. The share of income going to each group was relatively steady. The half with lowest income reported a little less than 15% of income, the 10%

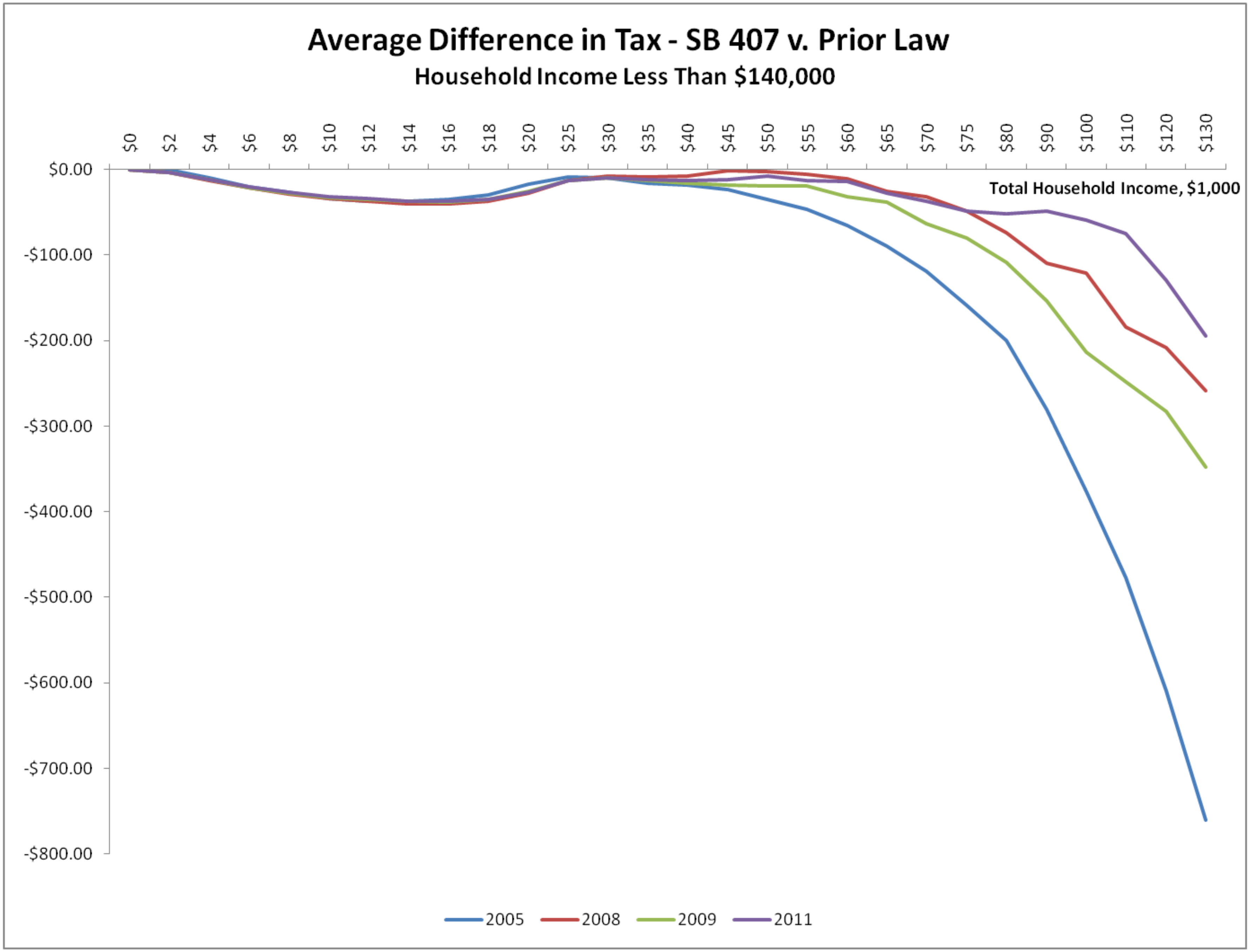
with highest incomes reported about 40% of income, and the remaining 40% of returns reported a little less than 50% of income.

The final graph shows annual growth rates of income reported by the three income groups. The highest income group shows the most volatility, because these households receive more of their income from volatile sources, such as capital gains.

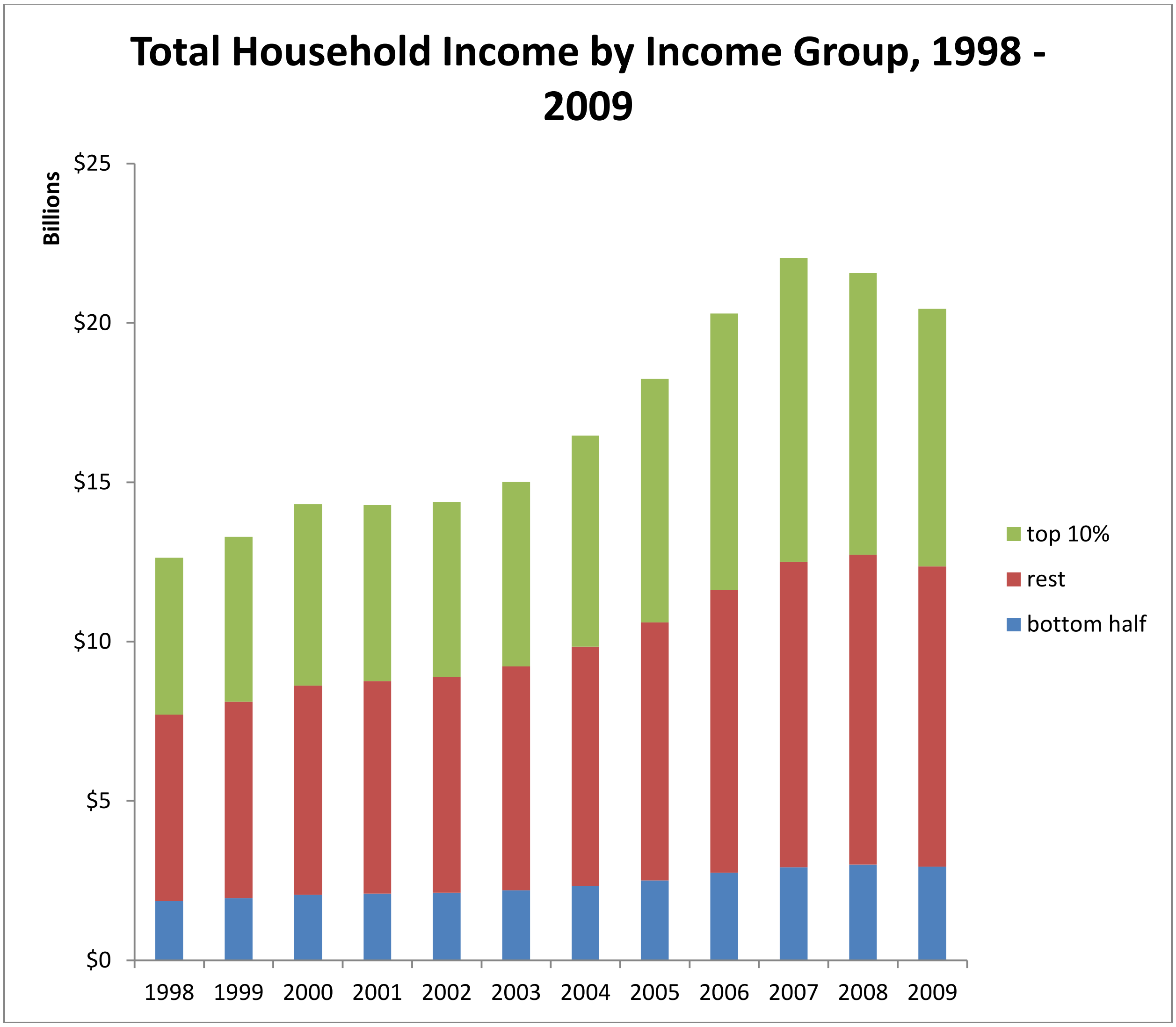


% Difference in Tax - SB 407 v. Prior Law
$0
$2
$4
$6
$8
$10
$12
$14
$16
$18
$20
$25
$30
$35
$40
$45
$50
$55
$60
$65
$70
$75
$80
$90
$100
$110
$120
$130
$140
$150
$175
$200
$300
$400
$500
Total Household Income, $1,000
0.0%
-10.0%
-20.0%
-30.0%
-40.0%
-50.0%
-60.0%
2005
2008
2009
2011


Average Difference in Tax - SB 407 v. Prior Law
$0.00
-$5,000.00
-$10,000.00
-$15,000.00
-$20,000.00
-$25,000.00
-$30,000.00
-$35,000.00
$0
$2
$4
$6
$8
$10
$12
$14
$16
$18
$20
$25
$30
$35
$40
$45
$50
$55
$60
$65
$70
$75
$80
$90
$100
$110
$120
$130
$140
$150
$175
$200
$300
$400
$500
Total Household Income, $1,000
2005
2008
2009
2011



Average Difference in Tax - SB 407 v. Prior Law
Household Income Less Than $140,000
$0.00
-$100.00
-$200.00
-$300.00
-$400.00
-$500.00
-$600.00
-$700.00
-$800.00
$0
$2
$4
$6
$8
$10
$12
$14
$16
$18
$20
$25
$30
$35
$40
$45
$50
$55
$60
$65
$70
$75
$80
$90
$100
$110
$120
$130
Total Household Income, $1,000
2005
2008
2009
2011



Total Household Income Reported on Income Tax Returns

Share Reported on Half of Returns with Lowest Incomes, 10% of Returns with Highest Incomes, Remaining 40% of Returns

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Income Shares												
bottom half	14.7%	14.7%	14.4%	14.7%	14.8%	14.7%	14.2%	13.7%	13.5%	13.2%	13.9%	14.4%
rest	46.3%	46.4%	45.9%	46.7%	47.1%	46.8%	45.6%	44.4%	43.7%	43.5%	45.1%	46.1%
top 10%	39.0%	39.0%	39.7%	38.7%	38.2%	38.6%	40.2%	41.9%	42.8%	43.2%	41.0%	39.6%
Total, $ billion	$12.627	$13.290	$14.306	$14.279	$14.378	$15.003	$16.464	$18.247	$20.289	$22.026	$21.563	$20.445

Explaining the Difference Between the Forecast and Actual Impacts of Senate Bill 407 (2003 Legislative Session)

Introduction

Senate Bill 407 (SB407, 2003) significantly revised Montana individual income tax law by reducing the top marginal income tax rate from 11% to 6.9%, reducing the number of tax brackets from ten to seven, and providing for a new bottom marginal tax rate of 1% (previously 2%). To offset the cost of reducing the top rate, the bill also capped the previously unlimited itemized deduction for federal income taxes paid during the tax year at $5,000 ($10,000 if married and filing a joint return). Finally, SB407 instituted a new nonrefundable capital gains tax credit equal to 1% of net positive capital gains income. These changes were scheduled to take effect for the 2005 tax year.

During the 2003 legislative session, the forecasted impacts of SB407 for TY2005 showed a reduction in total tax liability for full-year residents of $26 million, which represented a 4.8% reduction in tax. A recent examination of actual returns filed for TY2005 showed the actual reduction to be about $100 million, which represents a reduction of over 13%. The actual reduction in tax is $74 million larger – *almost three times larger* – than the forecast reduction. This document provides an explanation for why the actual impact of SB407 is so much larger than that predicted during the 2003 session.

Before getting into more detailed explanations, it's apparent that one reason for the difference is that many of the factors that influence total tax liability are simply much larger than anticipated during the 2003 session. This is illustrated in the following table.

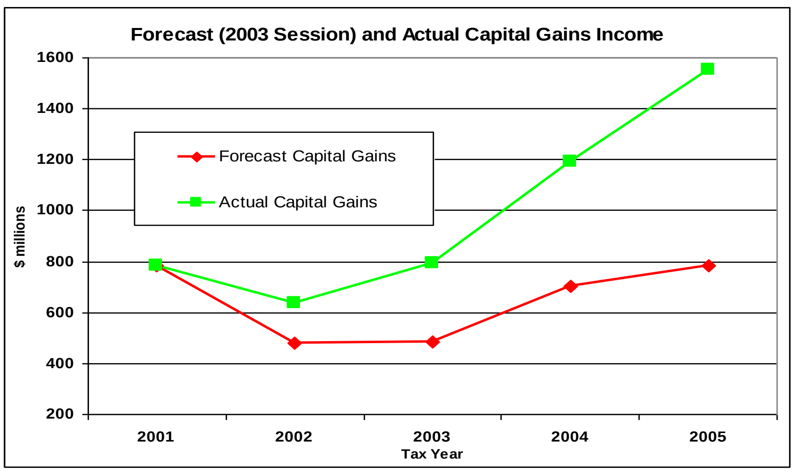
Difference Between 2003 Session Forecast and TY2005 Actual Amounts For Selected Items of Information

Item of Information	2003 Session Forecast	TY2005 Actual Amount	Difference	% Difference
Households	384,220	402,271	18,051	4.7%
Montana Adjusted Gross Income	14,419,492,000	16,773,601,215	2,354,109,215	16.3%
Capital Gains Income	783,716,244	1,554,054,359	770,338,115	98.3%
Montana Taxable Income	9,790,706,782	11,927,345,254	2,136,638,472	21.8%
Montana Tax Liability - Old Law	547,200,205	752,790,057	205,589,852	37.6%
Montana Tax Liability - SB407	521,141,556	652,487,295	131,345,739	25.2%
SB407 v. Old Law Tax Liability	(26,058,649)	(100,302,762)	(74,244,113)	284.9%

First, the population of taxpayers is almost 5% higher than those used to forecast the impact of SB407. This could be important depending on the income levels of these additional 18,000 households.

Montana adjusted gross income (MAGI) is $2.4 billion (over 16%) higher than forecast. Obviously, a higher level of income will result in a larger total tax liability under both old law and under SB407, and would very likely result in a larger dollar *difference* between old law tax and SB407 tax than that predicted during the 2003 session. As following discussions indicate, however, more important is where this growth in income occurred across different income brackets, and in the types of income that grew relatively faster or slower.

For example, when looking at the new 1% capital gains tax credit, differences in the forecast and actual growth of capital gains income will contribute to the overall differences in forecast and actual tax liabilities. As the above table shows, actual capital gains income in TY2005 turned out to be nearly twice as large as forecast during the 2003 session.



The chart to the right shows the 2003 forecast of capital gains income, and the actual growth in capital gains income over the period 2001-2005.

In TY2005, the *forecasted* amount of capital gains income would have resulted in a tax credit of about $8 million; but the actual amount of capital gains income resulted in a tax credit of nearly $16 million. The difference in these two credit amounts alone explains nearly $8 million of the $74 million difference between the forecast and actual difference between old law and SB407 law total tax liability.

While gross income was16% higher than forecast, taxable income – the income subject to tax after deductions and exemptions – was $2.14 billion (nearly 22%) higher than forecast. The fact that gross income was 16% higher than forecast, while taxable income was 22% higher suggests that there may have been a fundamental shift in the relationship between gross income and taxable income between the time when the forecast was made and when actual results became available. These implications of a fundamental shift in this relationship are discussed in greater detail in the following section.

The last three lines in the table show the forecast and actual TY2005 amounts for tax liability under old law, under SB407, and the difference between old law and SB407 liability.

Actual TY2005 tax liability under SB407 was $131.3 million (*over 25%*) higher than the amount that was forecasted during the 2003 session. This in itself is not surprising given that there is an additional $2.14 billion of income subject to tax above the amount projected. At the TY2005 actual average tax rate of 5.6%, this additional $2.14 billion of taxable income translates into an additional $120 million of liability. Given that incomes were so much higher than originally forecast, it is not surprising that tax liability also is much higher than forecast.

More surprising, however, is how much higher TY2005 tax liability actually would have been under *old law* relative to the amount that was forecast. As it turns out, actual liability under old law is almost $206 million (*nearly 38%*) higher than the amount originally forecast under old law.

Actual tax liability for all full-year resident taxpayers under SB407 was $652.5 million; tax liability for these taxpayers would have totaled $752.8 million if old law had been in place in TY2005. The difference between these two figures is the previously reported and widely discussed $100.3 million.

While it is interesting to note that the difference in tax liability between old law and SB407 law is $100 million, the real reason for this difference lies in why actual tax liability under SB407 is 25% higher than forecast, but actual tax liability under old law is nearly 38% higher than forecast; because it is this remarkable growth in tax liability under *old law* that is largely responsible for the *difference* between old law tax and SB407 tax.

To illustrate, if tax liability under old law had also grown by 25%, then total tax liability under old law would have been $684 million. This would have resulted in a $32 million reduction in liability as a result of SB407, which represents a 4.7% reduction, as opposed to the 13% reduction that actually occurred.

Following sections discuss in greater detail the reasons for the difference between forecast and actual tax liability under old law and SB407 law.

How Was the Forecast Made?

To understand the difference between the forecast and actual impacts of SB407 it is important to understand the components used in forecasting the original impact, and how that forecast was made.

There are essentially three components used in forecasting the impacts of any individual income tax reform proposal. Any difference between forecasted impacts and actual impacts must be attributable to one, or all, of these three main components that make up the forecasting process. These include:

- the 5-year simulation model used by both the administrative and legislative branches of state government for revenue estimation purposes;
- the forecast growth rates contained in HJR2 that are integral to this model; and
- the computer program that is applied to the model and designed to forecast the impacts of any specific piece of legislation relative to the current law *baseline* model forecast.

This discussion assumes that the last item – *the computer program applied to the model to forecast the impacts of SB407 relative to the baseline impacts* – does not explain any of the difference between forecast and actual impacts of SB407. First, the changes to the tax structure that were included in SB407 are very straightforward and extremely easy to program. More importantly, because the same computer programming/modeling was applied to both the original forecast and the calculation of the actual impact, the computer programming could not contribute to any of the difference.

This leaves the 5-year simulation model itself, and the growth parameters in HJR2 that are integral to that model.

5-Year Simulation (Revenue Forecasting) Model and Growth Rates

There were at least three significant problems with the simulation model itself that prevented it from accurately forecasting the impacts of SB407. Two of these problems relate to the income growth rates that were used in the model; the third problem pertains to the interaction between federal and state individual income taxes that arises as a consequence of Montana's itemized deduction for federal taxes.

Income Growth Rates

First, the forecast of income growth rates used in the original forecast was not accurate; particularly with respect to the forecast growth rate of capital gains income. This latter growth rate is particularly important because of:

- the effect of the new capital gains tax credit on state tax liabilities;
- the effect of unanticipated reductions in federal tax rates applied to capital gains income not contemplated in the model; and
- how the reduced federal tax rates on capital gains income acted to change the relationship between federal tax liabilities and income.

The following table provides a comparison of the forecast growth rates used in the tax reform simulation model used to forecast the impacts of SB407, and the actual growth rates that occurred over the period 2001-2005. For reference, the actual amount of each item of income reported on TY2005 full-year resident income tax returns is shown in the last column of the table.

Comparison of Forecast and Actual Growth Rates
Individual Income Tax Income Items
Tax Year 2001 to Tax Year 2005

Item of Income	Forecast	Actual	% Difference	TY2005 Amount
Wage and Salary Income	**12.0%**	**20.3%**	**8.3%**	**10,840,673,693**
Interest Income	-9.4%	-27.5%	-18.1%	480,087,683
Dividend Income	6.4%	53.1%	46.7%	463,027,085
Net business Income	-2.7%	21.3%	24.0%	749,587,514
Capital Gains Income	**-0.3%**	**97.8%**	**98.0%**	**1,554,054,359**
Supplemental Gains Income	1.7%	80.9%	79.2%	77,631,349
Rent, Royalties, Partnerships, etc.	**24.5%**	**87.9%**	**63.4%**	**1,704,629,493**
IRA Distributions	13.1%	16.5%	3.4%	308,394,240
Pensions/Annuities	**15.1%**	**25.5%**	**10.5%**	**1,216,408,584**
Social Security Income	21.5%	39.7%	18.2%	359,184,070
Farm Income	35.6%	-11.8%	-47.5%	(125,935,382)
Other Income	5.6%	-216.4%	-222.0%	(70,992,520)
Federal Adjusted Gross Income	**10.2%**	**27.5%**	**17.3%**	**17,188,787,002**

With the exceptions of interest income, farm income, and other income, the actual rate of growth of all income items exceeded the forecast growth rates, in most cases substantially. Wage and salary income, forecast to grow 12% over this time period actually grew by 20.3%. Capital gains income was forecast to remain constant, but instead nearly doubled. Rent, royalty, and partnership income, forecast to grow by almost 25% grew by nearly 88%. Pension and annuity income, forecast to grow by 15% grew by 25%. These four items of income comprise roughly 90% of total income.

As a result of the above differences between forecast and actual growth rates, federal adjusted gross income, which had been forecast to grow by just over 10% over this time frame, actually grew by almost 28%. These differences in growth rates explain why actual TY2005 tax liability under SB407 is so much larger than forecast liability.

The second problem with the model is that it applies the exact same growth rates for each income type to all households. To the extent that certain types of income (e.g., capital gains income, or wage and salary income) grow at dramatically different rates between households in different income brackets, the model does not accurately forecast future tax liabilities by income bracket.

The following table shows how total household income has grown from tax year 2001 to tax year 2005, by decile group[1]. Over this time period, total household income grew by almost $4 billion (27.8%), which represents an average *annual* growth rate of about 6.3%. Because part of this growth reflects a 4.7% increase in the number of households paying tax, overall growth in average income per household drops to 22.1%, which represents about a 5.1% average annual growth rate.

Distribution of Total Household Income (TY2001 and TY2005)
Change in Total Income; Share of Change; and % Change in Average Income - by Decile Group - TY2001 to TY2005

	TY2001			TY2005					
Decile Group	Total Households	Total Income	Average Income	Total Households	Total Income	Average Income	Change in Total Income	Share of Change	% Change in Ave. Inc.
1	37,845	88,462,369	$2,337	39,612	106,924,156	$2,699	18,461,787	0.5%	15.5%
2	37,845	238,783,222	$6,310	39,612	288,191,812	$7,275	49,408,590	1.2%	15.3%
3	37,845	403,885,977	$10,672	39,612	481,280,846	$12,150	77,394,869	2.0%	13.8%
4	37,845	581,829,512	$15,374	39,612	692,261,510	$17,476	110,431,998	2.8%	13.7%
5	37,845	782,304,874	$20,671	39,612	936,907,340	$23,652	154,602,466	3.9%	14.4%
6	37,845	1,042,375,101	$27,543	39,612	1,254,071,189	$31,659	211,696,088	5.3%	14.9%
7	37,845	1,383,401,057	$36,554	39,612	1,668,580,016	$42,123	285,178,959	7.2%	15.2%
8	37,845	1,818,645,709	$48,055	39,612	2,209,445,159	$55,777	390,799,450	9.8%	16.1%
9	37,845	2,419,798,946	$63,940	39,612	2,961,259,090	$74,757	541,460,144	13.6%	16.9%
10	37,845	5,519,874,054	$145,855	39,614	7,648,491,317	$193,075	2,128,617,263	53.6%	32.4%
Total	**378,450**	**14,279,360,821**	**$37,731**	**396,122**	**18,247,412,435**	**$46,065**	**3,968,051,614**	**100.0%**	**22.1%**
10A	12,615	1,019,006,810	$80,777	13,204	1,265,658,629	$95,854	246,651,819	6.2%	18.7%
10B	12,615	1,253,943,681	$99,401	13,204	1,593,600,123	$120,691	339,656,442	8.6%	21.4%
10C	12,615	3,246,923,563	$257,386	13,206	4,789,232,565	$362,656	1,542,309,002	38.9%	40.9%

Income growth across decile groups was not uniform, however. In tax year 2001, households in the 10th decile group received 38.7% of total income. But over the period 2001 to 2005 nearly 54% of the total growth in income accrued to households in the top decile group, so that by 2005 this decile group received 41.9% of total income. Average income for households in the top decile group increased by 32.4% over this time period, which is twice as fast or more than any other decile group. For the top one-third of the top decile group, average income increased by 41% over this time period.

The following table provides the same information with respect to capital gains income.

Growth in capital gains income is even more tilted towards higher income households than was growth in total income. Overall, capital gains income nearly doubled over the period 2001 to 2005; but the vast majority (nearly 90%) of the *growth* in capital gains income accrued to households in the top decile group. About 77% of the growth in capital gains income accrued to the top one-third of households in the top decile group.

[1] Decile groups divide the population of taxpayers/households into ten groups each containing 10% of the population. Taxpayers and households having the lowest incomes are in the first decile group, and taxpayers and households with the highest incomes are in the top decile group. In this and the following table, the top decile group is broken out into thirds with the very highest income households in the top third of the 10th decile.

Distribution of Total Capital Gains Income (TY2001 and TY2005)
Change in Capital Gains Income; Share of Change; and % Change in Ave. Capital Gains Inc. - by Decile Group - TY2001 to TY2005

	TY2001			TY2005					
Decile Group	Total Households	Total Capital Gains	Average CG Income	Total Households	Total Income	Average CG Income	Change in CG Income	Share of Change	% Change in Ave. CG
1	5,629	252,095	$45	5,724	545,950	$95	293,855	0.0%	113.0%
2	5,297	3,363,460	$635	5,476	2,987,488	$546	(375,972)	0.0%	-14.1%
3	5,763	5,022,867	$872	5,852	7,082,767	$1,210	2,059,900	0.3%	38.9%
4	6,398	7,819,574	$1,222	6,228	11,136,318	$1,788	3,316,744	0.4%	46.3%
5	7,250	12,188,568	$1,681	6,934	15,740,005	$2,270	3,551,437	0.5%	35.0%
6	8,312	16,879,227	$2,031	8,388	22,094,597	$2,634	5,215,370	0.7%	29.7%
7	9,764	24,764,804	$2,536	10,003	34,052,299	$3,404	9,287,495	1.2%	34.2%
8	11,272	33,896,669	$3,007	11,728	57,483,399	$4,901	23,586,730	3.1%	63.0%
9	13,912	52,330,111	$3,762	14,608	90,838,350	$6,218	38,508,239	5.0%	65.3%
10	21,761	614,110,139	$28,221	23,310	1,292,393,472	$55,444	678,283,333	88.8%	96.5%
Total	**95,358**	**770,627,514**	**$8,081**	**98,251**	**1,534,354,645**	**$15,617**	**763,727,131**	**100.0%**	**93.2%**
10A	5,665	30,654,497	$5,411	6,012	59,314,490	$9,866	28,659,993	3.8%	82.3%
10B	6,812	59,064,196	$8,671	7,311	121,152,618	$16,571	62,088,422	8.1%	91.1%
10C	9,284	524,391,446	$56,483	9,987	1,111,926,364	$111,337	587,534,918	76.9%	97.1%

For households in the top decile group, *average* capital gains income also nearly doubled (96.5%), while growth in average gains in the first 7 decile groups averaged around 33%; and growth in average gains in the 8th and 9th decile group averaged around 64%.

As a result, whereas in 2001 households in the top decile group received 79.7% of all capital gains income, by 2005 these households received 84.2% of all capital gains. In 2005, the top 4% of highest income households received 75% of all capital gains income.

Importantly, the much faster growth in capital gains income relative to total income shifted the relationship between capital gains income and total income. For households in the top decile group, capital gains comprised 11% of total income in 2001; by 2005 capital gains comprised 17% of total income. For households in the top one-third of the top decile group, capital gains comprised 16% of total income in 2001 and almost one-quarter (23%) of total income in 2005.

Federal Tax Law and the State Deduction for Federal Income Tax

More than anything else, understanding why there is a $100 million dollar difference between old law and SB407 law requires a thorough understanding of the relationship between federal and state income tax law.

Prior to SB407 (i.e., under old law), a taxpayer's federal income taxes paid during the tax year could be deducted in full for state income tax purposes. Because of this interaction between federal and state tax liabilities, an accurate forecast of state tax liabilities requires an accurate forecast of federal tax liabilities for all taxpayers who deduct their federal taxes. Consequently, the simulation model used to forecast revenue (and the impacts of proposed legislation) goes to great lengths to provide a reasonably accurate forecast of federal tax liabilities for each taxpayer. Indeed, over half the programming in the model is devoted to this task alone.

For taxpayers who itemized their deductions for state income tax purposes, the relationship between federal tax liability and state tax liability under pre-SB407 law meant that *the higher the taxpayer's federal tax the lower his state tax, and the lower the taxpayer's federal tax the higher his state tax*.

During the 2003 legislative session, the forecast of the change in tax liability from adopting SB407 relied on a forecast of tax liability under old law and under SB407 law. The forecast of tax liability under old law was based on federal tax law as it was known at the time of the forecast.

Unfortunately, there have been many changes to federal tax law since the passage of SB407 that were not included in the simulation model used to make the forecast. For the most part, these federal changes either accelerated the original schedule of federal tax reductions in the *Economic Growth and Tax Relief Reconciliation Act of 2001*, or enacted additional federal tax reductions.[2] Because a significant feature of these federal tax changes included a greatly reduced tax rate on capital gains income, and because nearly all capital gains income accrues to high income households, these changes to federal law acted to greatly benefit high income households.

Because these interim federal tax law changes were not known at the time of the original estimate, the forecasting model overstated the forecast of federal tax liabilities. *This acted to overstate the amount of federal tax that would be deducted for state tax purposes, and thereby understate state tax liabilities under old law.*[3]

Consequently, this shift in the relationship between total household income and federal tax liability resulted in a much larger than anticipated difference between state liability under old law and under SB407 law, primarily because the forecast of liability under old law was greatly underestimated.

The following taxpayer example illustrates the underlying relationship between capping the deduction for federal taxes and the reduction in the top tax rate, and how a shift in this relationship would account for a difference in the forecast and actual impact of SB407.

In the example, assume the taxpayer was originally forecast to have TY2005 income of $1,000,000; a federal tax deduction of $300,000 under old law, and a 4.4%

[2] Federal tax law changes included in the *Jobs and Growth Tax Relief Reconciliation Act of 2003*; the *American Jobs Creation Act of 2004*; and the *Working Families Tax Relief Act of 2004*; were not included in the simulation model used to forecast the impacts of SB407. For the most part, these changes acted to reduce federal tax liabilities, in no small part by reducing federal tax rates on capital gains income.

[3] On the other hand, overstating the forecast of federal tax in itself would have little impact on the forecast of liability under SB407 because the deduction for federal taxes is capped at $5,000.

reduction in liability as a result of capping the deduction at $5,000 and reducing the top marginal rate from 11% to 6.9%.

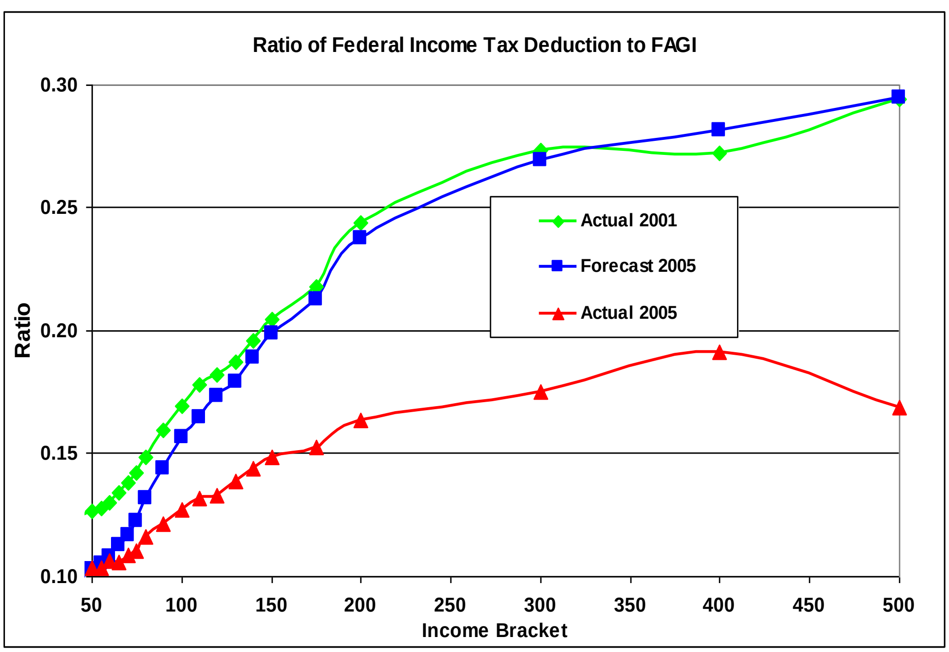
Shift in Relationship Between Federal Income Tax and Total Income - Taxpayer Example

	Forecast		Actual	
	Old Law	**SB407**	**Old Law**	**SB407**
Total Income	1,000,000	1,000,000	1,600,000	1,600,000
FITD	300,000	5,000	320,000	5,000
Other Ded	135,000	135,000	135,000	135,000
Total Ded	435,000	140,000	455,000	140,000
Pers Exemption	2,800	2,800	2,800	2,800
Taxable Income	562,200	857,200	1,142,200	1,457,200
Tax @ 11%	61,842		125,642	
Tax @ 6.9%		59,147		100,547
Difference		(2,695)		(25,095)
% Change		**-4.4%**		**-20.0%**

If in fact the actual relationship between income and the deduction for federal income taxes turns out to be that income grew substantially faster than forecast, while the deduction for federal taxes grew only modestly more than forecast, then the percentage reduction in tax due to SB407 would be much larger than what was forecast.

As illustrated in the example, suppose the taxpayer's income actually grew to $1,600,000 but the deduction for federal taxes only increased an additional $20,000 over the amount forecast. In this case the resulting tax reduction is 20%, explained mostly by the fact that the forecast ratio of federal tax liability to income of 30% ($300,000 / $1,000,000) actually turned out to be just 20% ($320,000 / $1,600,000).

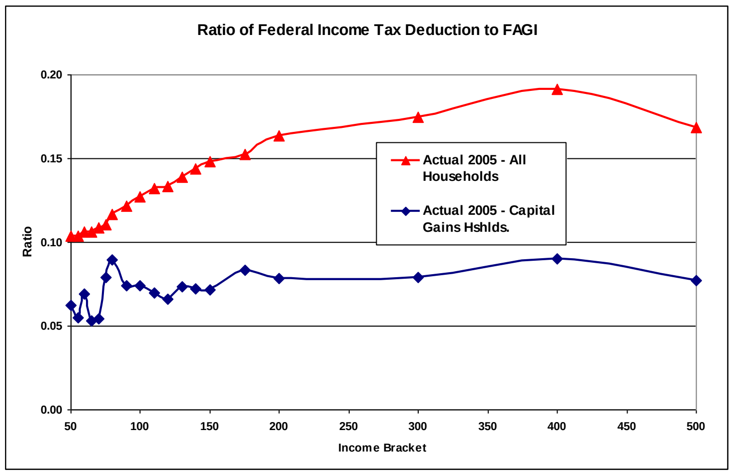
The following chart shows how the relationship between federal income taxes and federal adjusted gross income (FAGI) shifted between the time the forecast was made and tax year 2005.



As the chart shows, the actual tax year 2001 ratio of total federal income taxes to gross income rose from around 10% for households with $50,000 of income to almost 30% for households in the top income bracket ($500,000 or more). The 2003 forecast of what this relationship would look like in tax year 2005 very closely mirrors the actual relationship that existed in tax year 2001.

But actual experience shows that this relationship changed substantially by tax year 2005. While the ratio of federal taxes to total income was still around 10% for households with $50,000 of income, the ratio rose to a high of 19% for households with incomes between $400,000 and $500,000 and then dropped to just 17% for households with incomes over $500,000.

Furthermore, for households with substantial capital gains income the ratio of federal tax paid during the tax year to gross income is even further below that of all households. The chart to the right compares actual TY2005 ratios for all households and those households where capital gains income comprises 50% or more of total income. For this latter group of households, the ratio varies between 5% and 9%, with the ratio for households in the top income bracket being about 8%.



Had the forecast relationship between federal taxes and gross income for all households actually occurred in TY2005, the itemized deduction for federal taxes would have been almost a half billion dollars higher, and total tax liability as much as $50 million lower. This would have reduced the *difference* between old law tax and SB407 tax from $100 million to $50 million.

The forecasted impact of SB407 inherently assumed that, for old law, incomes and the deduction for federal income taxes would grow commensurately based on what was then federal tax law. But because incomes grew more rapidly than forecast, while federal income taxes grow more slowly than forecast, *the tax reduction effect of the rate reduction from 11% to 6.9%*[4] *outweighed the offsetting tax increase effect of capping the deduction for federal taxes paid far more than forecast*, with the end result being that the actual net impact of SB407 is much larger than originally forecast.

[4] Note that when all other things are held constant, for taxpayers with very high incomes a reduction in the top marginal rate alone from 11% to 6.9% represents a reduction of 37.3% (11 – 6.9 = 4.1 / 11 = .373).

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EXPLAINING THE DIFFERENCE BETWEEN THE FORECAST AND ACTUAL IMPACTS OF SENATE BILL 407

Montana Department of
REVENUE

January, 2007

Explaining the Difference Between the Forecast and Actual Impacts of Senate Bill 407 (2003 Legislative Session)

Executive Summary

Senate Bill 407 (SB407,2003) significantly changed Montana's individual income tax by:

- reducing the top marginal tax rate from 11% to 6.9%;
- capping the previously unlimited deduction for federal income tax at $5,000 ($10,000 if married and filing a joint return); and
- providing for a new tax credit equal to 1% of capital gains income.

During the 2003 session, SB407 was forecast to reduce tax year 2005 tax liability for full-year residents by $26 million, which represented a 4.8% reduction. Information from actual TY2005 returns shows this reduction to be $100 million, representing a reduction of over 13%. The difference between these figures can be attributed to a variety of factors, including the following:

- Montana adjusted gross income is 16.3% higher than originally forecast, and taxable income is 21.8% higher. Higher incomes likely result in a higher *difference* between old law and SB407 law.

- As a result of higher incomes, actual tax liability under SB407 is $131.3 million (25.2%) higher than forecast. Even more remarkable, tax liability under old law would have been $205.6 million (37.6%) higher than what had been forecast. It is this enormous growth in what would have been tax liability under *old law* that results in the $100 million *difference* between old law and SB407 law. Had tax liability under old law also been 25.2% higher than forecast, the difference between old law and SB407 law liability would have been just $32 million, which represents a 4.7% reduction.

- Over the period 2001-2005 growth in income was skewed largely to higher income households. Total household income grew by about $4 billion (28%), with nearly 54% of this amount accruing to the top 10% of households as measured by income.

- More importantly, capital gains income nearly doubled over this period, with 89% of the growth accruing to the top 10% of households. One consequence of this growth in capital gains income is that the capital gains tax credit is double the forecast credit, which accounts for about $8 million of the difference between the forecast and actual impact of SB407.
- After the forecast had been made, the federal government changed federal income tax law in a manner that reduced federal taxes for most

taxpayers, but reduced federal taxes for high income households much more than for lower income households.

- In particular, federal tax rates applied to capital gains income were greatly reduced. This acted to greatly benefit high income households, as in Montana the top 4% of all households as measured by income received 75% of all capital gains income in TY2005, and capital gains comprised nearly one-quarter of all income received by these households.

- The original estimate of the change in tax liability from adopting SB407 reflected the net effect of a large drop in total liability from reducing the top marginal rate from 11% to 6.9%, and the offsetting increase in liability from capping the previously unlimited deduction for federal income taxes at $5,000. The net effect of these two offsetting features depends entirely on the relationship between federal income taxes and income. Generally speaking, the smaller the ratio of federal taxes to income, the greater the tax reduction effect of reducing the top marginal rate and the smaller the offsetting effect of capping the deduction for federal taxes.

- The changes to federal tax law that occurred after the original estimate of the impact of SB407 was made acted to greatly reduce the ratio of federal tax to income, particularly in high income households where capital gains comprised a large portion of total income. Because these federal tax law changes were not included in the forecasting model used to estimate the impacts of SB407, the model significantly overstated the forecast of federal tax liabilities. This acted to overstate the amount of federal tax that would be deducted for state tax purposes, and thereby greatly understate state tax liabilities *under old law*.

- Because incomes grew more rapidly than forecast, while federal income taxes grow more slowly than forecast, *the tax reduction effect of the rate reduction from 11% to 6.9% outweighed the offsetting tax increase effect of capping the deduction for federal taxes paid far more than forecast*, with the end result being that the actual net impact of SB407 is much larger than originally forecast.

- In short, the shift in the relationship between total household income and federal tax liability that arose because of changes to federal law, resulted in a much larger than anticipated difference between state liability under old law and under SB407 law, primarily because the forecast of liability under old law was underestimated proportionately more than the forecast of liability under SB407 was underestimated. This effect is particularly pronounced for the 1,586 households in the highest income bracket (households with income of $500,000 or more) which received almost half of the total tax reduction benefit of SB407.

The Revenue and Taxpayer Impacts of the Income Tax Provisions of SB 407

Tax Policy and Research
Montana Department of Revenue
December 2006

Executive Summary

Senate Bill 407, enacted in the 2003 legislative session, made significant revisions to Montana's individual income tax system. The changes became effective in the 2005 tax year. Our study of actual 2005 tax returns reveals the following conclusions.

- The total amount of tax reduction granted by this legislation was almost four times greater than estimated at the time of enactment: $100.3 million vs. the 2003 prediction of $26 million.

- Higher income taxpayers received more tax reduction than predicted, and lower income taxpayers received less. Households earning $500,000 or more annually received 47.7% of the tax reduction as compared to the 22.9% share predicted in 2003. These are the details:

  Annual incomes less than $65,000: This income range includes 81% of Montana households (320,942 households). These households received 7.2% of the reduction: $7.2 million or approximately $23 dollars for each household. The tax reduction for these households is about 12% less than the $8.2 million predicted in 2003.

  Annual incomes between $65,000 and $150,000: This income range includes 15.9% of Montana households (63,015 households). These households received 16.9% of the reduction: $17.0 million or $269 for each household. The tax reduction for these households is approximately 194% greater than the $5.8 million predicted in 2003.

  Annual incomes between $150,000 and $500,000: This income range includes 2.6% of Montana households (10,460 households). These households received 28.2% of the reduction: $28.3 million or $2,705 per household. The tax reduction for these households is approximately 365% greater than the $6.1 million predicted in 2003.

  Annual incomes of $500,000 and up: This income range includes 0.4% of Montana households (1,567 households). These households received 47.6% of the tax reduction: $47.8 million or $30,499 per household. The tax reduction for these households is 701% greater than the $6 million predicted in 2003.

- The majority of households—65% or about two-thirds—experienced only a small change (less than $50) in their tax. The other third either received a tax cut of $50 or more (29% of households) or paid at least $50 more (6% of households).
  - Who received the tax cuts of $50 or more? Only at income levels of $70,000 or more did a majority of households see a tax reduction of at least $50, with the percentage rising steadily to 94% for households with incomes of at least $500,000.
  - Who paid at least $50 more in taxes? The percentage of households paying at least $50 more is highest (20%) for households with incomes between $60,000 and $75,000.

- To put these numbers in context, the average tax relief for the 1586 households earning $500,000 or more, $30,499, is greater than the $29,150 average annual pay of Montana jobs covered by workers compensation, as reported by the Bureau of Labor Statistics.

Introduction

The 2003 legislature passed SB407, which made significant changes to Montana's income tax, with the expectation that the changes would reduce income tax revenue. To replace the lost income tax revenue, SB407 imposed a limited sales tax on accommodations and rental cars and increased the excise taxes on cigarettes and tobacco products. The overall bill was intended to increase revenue from the time the sales and excise tax increases went into effect in 2003 until the income tax provisions went into effect in 2005. It was intended to be revenue neutral for the first full-year of the income tax changes and then result in net revenue reductions in later years.

SB407 made three significant changes to Montana's income tax:

- It restructured the rate table, reducing the number of rate brackets from ten to six, reducing the bottom rate from 2% to 1%, reducing the top rate from 11% to 6.9%, and reducing the income at which the top rate is effective from $82,400 to $13,900.
- It reduced the effective rates on capital gains income by giving a nonrefundable tax credit equal to 1% of capital gains income in 2006 and 2007, and 2% of capital gains income beginning in 2008.
- It capped the itemized deduction for federal income taxes at $5,000 for single taxpayers and married couples filing separately, and $10,000 for married couples filing joint returns. (Previously, federal income taxes paid during the tax year could be deducted in full.)

During the 2003 session, the department estimated the revenue impacts of these changes. The estimates were made using the database of 2001 full-year resident income tax returns. Future years' tax liabilities were calculated from these returns using the rate tables and other provisions that would have been in place under the old law and using the rate tables and other provisions in SB407. The differences in individual tax liabilities were used to estimate the total impact of SB407 and the distribution of those impacts among income groups.

The total tax reduction was estimated to be $26.0 million in 2005, with lower and higher income taxpayers receiving higher percentage reductions and middle income taxpayers seeing smaller percentage reductions.

The actual impact in 2005 was estimated using the database of 2005 full-year resident income tax returns. For each return, tax liability for that return using the rate tables and other provisions that would have been in place without SB407 was calculated and compared to the actual 2005 tax liability.

The total 2005 tax reduction was $100.3 million. The percentage reductions going to lower and higher income taxpayers were larger than expected in 2003, and the percentage reductions going to middle income taxpayers were smaller.

Tax Reduction Due to SB407

Table 1 shows the actual tax liability reported on full-year resident's income tax returns for 2005, the calculated tax liability for those returns under the pre-SB407 law, and the difference, for thirty-five income brackets and in total. The left half of the table shows the range of household incomes included in each bracket, the number of households in that bracket, and the total of their household income. The right half of the table shows the total of calculated pre-SB407 law tax liability for households in the bracket, their actual 2005 tax, and the difference.

Table 1
Impact of SB407 on Full-Year Resident's 2005 Income Tax

Income Brackets			Tax Liability of Households in Bracket		
Income Range	**Number of Households in Bracket**	**Total Income of Households in Bracket**	**Old Law (Calculated)**	**SB407 (Actual)**	**Difference Due to SB 407**
$ 0 - $ 1,999	13,549	$14,568,046	$37,361	$31,623	($5,738)
$ 2,000 - $ 3,999	17,822	53,586,607	35,443	21,751	(13,692)
$ 4,000 - $ 5,999	18,096	90,325,046	364,236	188,262	(175,974)
$ 6,000 - $ 7,999	17,239	120,605,549	821,058	470,191	(350,867)
$ 8,000 - $ 9,999	16,723	150,374,690	1,268,971	822,082	(446,889)
$ 10,000 - $ 11,999	16,095	176,940,455	1,777,699	1,236,833	(540,866)
$ 12,000 - $ 13,999	15,301	198,715,462	2,327,366	1,765,832	(561,534)
$ 14,000 - $ 15,999	14,825	222,406,117	2,931,906	2,388,450	(543,456)
$ 16,000 - $ 17,999	14,645	248,725,138	3,630,271	3,115,719	(514,552)
$ 18,000 - $ 19,999	13,799	261,978,247	4,214,879	3,805,641	(409,238)
$ 20,000 - $ 24,999	29,860	669,444,654	12,572,997	12,050,667	(522,330)
$ 25,000 - $ 29,999	24,717	678,016,388	14,553,992	14,328,423	(225,569)
$ 30,000 - $ 34,999	21,401	694,260,349	16,829,559	16,616,875	(212,684)
$ 35,000 - $ 39,999	18,447	690,729,036	18,104,498	17,807,491	(297,007)
$ 40,000 - $ 44,999	16,572	703,225,278	19,712,780	19,407,519	(305,261)
$ 45,000 - $ 49,999	14,713	698,583,047	20,693,530	20,346,593	(346,937)
$ 50,000 - $ 54,999	13,603	713,485,337	22,107,997	21,636,111	(471,886)
$ 55,000 - $ 59,999	12,312	707,604,871	22,715,489	22,141,875	(573,614)
$ 60,000 - $ 64,999	11,223	700,927,264	23,658,488	22,927,933	(730,555)
$ 65,000 - $ 69,999	9,832	662,889,471	23,159,662	22,274,271	(885,391)
$ 70,000 - $ 74,999	8,699	630,067,312	23,152,561	22,120,389	(1,032,172)
$ 75,000 - $ 79,999	7,549	584,511,701	22,197,411	20,998,845	(1,198,566)
$ 80,000 - $ 89,999	11,930	1,010,880,934	40,332,978	37,952,826	(2,380,152)
$ 90,000 - $ 99,999	8,388	794,471,339	33,571,802	31,218,435	(2,353,367)
$100,000 - $109,999	5,670	593,702,631	26,398,755	24,266,498	(2,132,257)
$110,000 - $119,999	4,092	469,651,011	21,698,819	19,748,858	(1,949,961)
$120,000 - $129,999	2,965	369,807,546	17,742,147	15,935,231	(1,806,916)
$130,000 - $139,999	2,210	297,572,548	14,866,524	13,187,310	(1,679,214)
$140,000 - $149,999	1,680	243,326,207	12,678,500	11,129,603	(1,548,897)
$150,000 - $174,999	2,957	477,414,023	26,035,950	22,444,951	(3,590,999)
$175,000 - $199,999	1,856	346,355,745	19,975,360	16,718,142	(3,257,218)
$200,000 - $299,999	3,585	863,144,801	54,094,354	44,084,486	(10,009,868)
$300,000 - $399,999	1,353	464,080,389	31,964,872	25,258,619	(6,706,253)
$400,000 - $499,999	709	316,123,141	22,612,623	17,883,401	(4,729,222)
$500,000+	1,567	2,123,623,903	173,936,488	126,143,942	(47,792,546)
TOTALS	**396,610**	**$18,287,752,624**	**$752,788,380**	**$652,485,816**	**($100,302,564)**

Table 2 shows the percentage reductions in total tax liability for each income bracket as they were estimated in 2003 and as they were calculated from the 2005 tax returns.

Table 2
Percentage Reductions in 2005 Income Tax
2003 Session Estimates and Actual

Income Bracket	2003 Estimate Difference	2003 Estimate % Difference	2005 Actual Difference	2005 Actual % Difference
$ 0 - $ 1,999	($7,739)	-40.2%	($5,738)	-15.4%
$ 2,000 - $ 3,999	(33,554)	-46.7%	(13,692)	-38.6%
$ 4,000 - $ 5,999	(262,205)	-47.9%	(175,974)	-48.3%
$ 6,000 - $ 7,999	(428,932)	-38.7%	(350,867)	-42.7%
$ 8,000 - $ 9,999	(521,943)	-32.7%	(446,889)	-35.2%
$ 10,000 - $ 11,999	(567,993)	-26.3%	(540,866)	-30.4%
$ 12,000 - $ 13,999	(581,633)	-19.7%	(561,534)	-24.1%
$ 14,000 - $ 15,999	(543,934)	-14.7%	(543,456)	-18.5%
$ 16,000 - $ 17,999	(431,887)	-9.6%	(514,552)	-14.2%
$ 18,000 - $ 19,999	(303,542)	-6.0%	(409,238)	-9.7%
$ 20,000 - $ 24,999	(348,382)	-2.4%	(522,330)	-4.2%
$ 25,000 - $ 29,999	(197,630)	-1.2%	(225,569)	-1.5%
$ 30,000 - $ 34,999	(319,622)	-1.7%	(212,684)	-1.3%
$ 35,000 - $ 39,999	(511,654)	-2.4%	(297,007)	-1.6%
$ 40,000 - $ 44,999	(573,135)	-2.6%	(305,261)	-1.5%
$ 45,000 - $ 49,999	(571,352)	-2.4%	(346,937)	-1.7%
$ 50,000 - $ 54,999	(606,941)	-2.5%	(471,886)	-2.1%
$ 55,000 - $ 59,999	(660,624)	-2.7%	(573,614)	-2.5%
$ 60,000 - $ 64,999	(737,230)	-3.0%	(730,555)	-3.1%
$ 65,000 - $ 69,999	(690,398)	-3.1%	(885,391)	-3.8%
$ 70,000 - $ 74,999	(619,209)	-3.0%	(1,032,172)	-4.5%
$ 75,000 - $ 79,999	(656,528)	-3.4%	(1,198,566)	-5.4%
$ 80,000 - $ 89,999	(1,048,222)	-3.4%	(2,380,152)	-5.9%
$ 90,000 - $ 99,999	(706,813)	-3.0%	(2,353,367)	-7.0%
$100,000 - $109,999	(505,442)	-2.9%	(2,132,257)	-8.1%
$110,000 - $119,999	(384,190)	-2.8%	(1,949,961)	-9.0%
$120,000 - $129,999	(406,914)	-3.7%	(1,806,916)	-10.2%
$130,000 - $139,999	(408,798)	-4.1%	(1,679,214)	-11.3%
$140,000 - $149,999	(352,659)	-4.5%	(1,548,897)	-12.2%
$150,000 - $174,999	(932,199)	-5.3%	(3,590,999)	-13.8%
$175,000 - $199,999	(831,445)	-5.9%	(3,257,218)	-16.3%
$200,000 - $299,999	(2,001,276)	-6.0%	(10,009,868)	-18.5%
$300,000 - $399,999	(1,447,824)	-7.4%	(6,706,253)	-21.0%
$400,000 - $499,999	(871,726)	-7.2%	(4,729,222)	-20.9%
$500,000+	(5,973,560)	-9.7%	(47,792,546)	-27.5%
TOTALS	**($26,047,135)**	**-4.8%**	**($100,302,564)**	**-13.3%**

Overall, the tax reduction was much larger than predicted in 2003. SB407 was predicted to reduce full-year resident's 2005 taxes by 4.8% or $26.0 million. Analysis of 2005 tax returns shows that the actual reduction was 13.3% or $100.3 million.
The impact by income bracket also is different than predicted in 2003. In general, the percentage reduction is larger than predicted for households with incomes less than $30,000. It is smaller than predicted for households with incomes between $30,000 and $65,000. For households with incomes over $65,000, the percentage reduction is larger than predicted, and for households with incomes over $90,000 it ranges from twice to over three times larger than predicted.

Figure 1 shows the predicted and actual percentage reductions listed in Table 2.

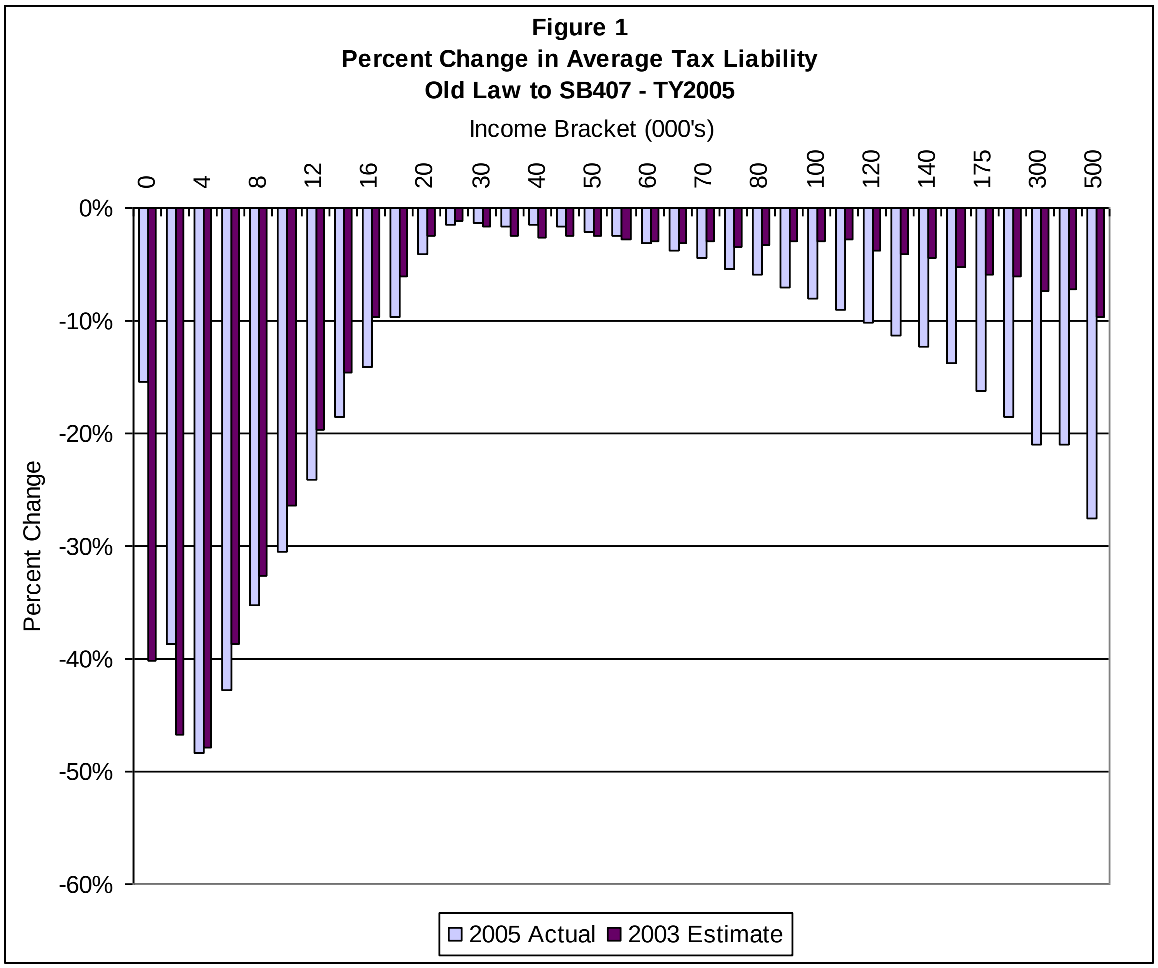


Table 3, on the next page, combines the income brackets in Tables 1 and 2 into five broad income groups and shows how the tax reduction was distributed among them. The two lowest groups combine the low and middle income brackets that received larger than expected reductions. The third group combines the middle income brackets that received smaller than expected reductions. The fourth and fifth groups combine the high income brackets that received larger than expected reductions.

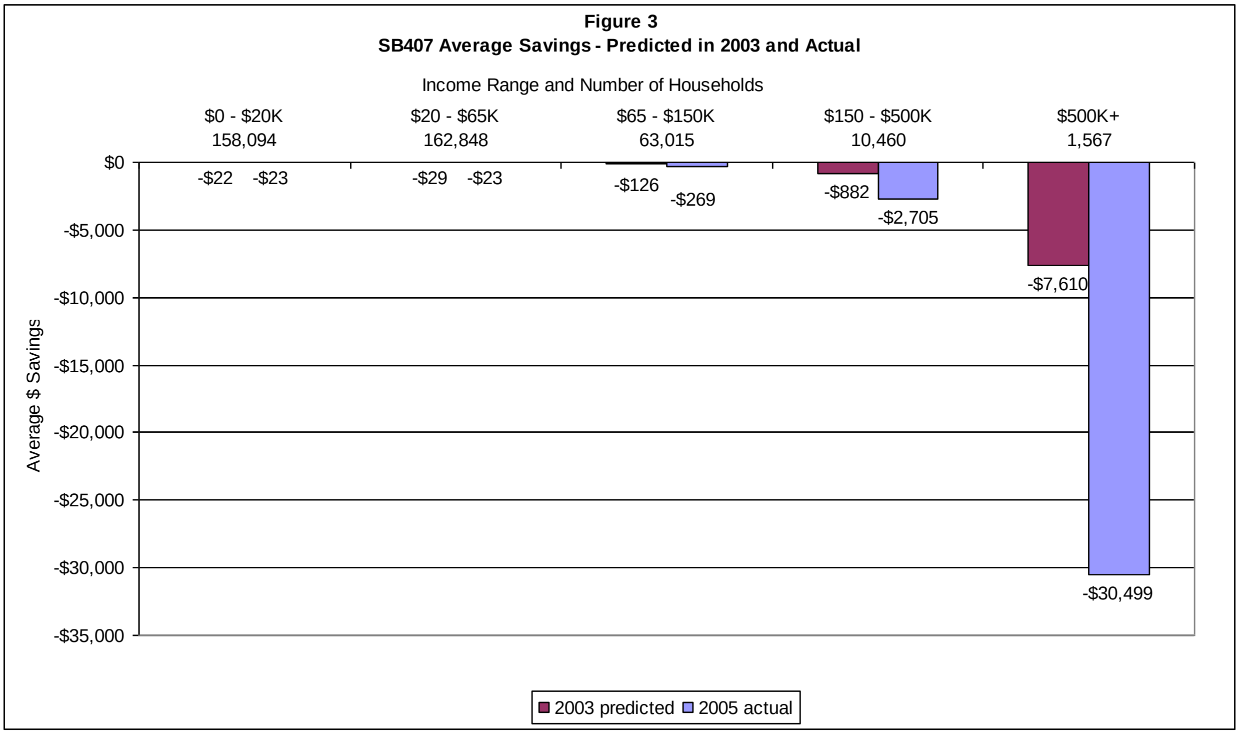
Table 3 2005 Income Tax Reductions from SB 407				
Income Bracket				
Income Range	Number of Households in Bracket	Percent of Households	Tax Reduction	Percent of Tax Reduction
$0 - $20,000	158,094	39.9%	($3,562,807)	3.6%
$20,000 - $65,000	162,848	41.1%	($3,685,842)	3.7%
$65,000 - $150,000	63,015	15.9%	(16,966,894)	16.9%
$150,000 - $500,000	10,460	2.6%	(28,293,560)	28.2%
$500,000 +	1,567	0.4%	(47,792,546)	47.6%
Total	**395,984**	**100.0%**	**($100,301,650)**	**100.0%**

Almost half of the tax cut went to the 0.4% of households with income over $500,000.

Figures 2 and 3 compare the 2003 predictions with the actual reductions for these five income groups.

Figure 2
SB407 Total Savings - Predicted in 2003 and Actual

In 2003, each of the three higher income groups was predicted to receive tax reductions totaling about $6 million. The actual reductions for these groups were much larger, and the difference is larger in each succeeding higher income group. Both of the lower income groups received smaller reductions than predicted in 2003.



Figures 4 and 5, on the next page, show the difference between the forecasted and actual impact of SB407 across income groups as a plot of average effective tax rates for each income bracket. The average effective tax rate is the total tax paid by households in an income bracket divided by the total of their household incomes.

Figure 4 and Figure 5 both show average effective tax rates under:

- the pre-SB407 (old) law using tax year 2005 return information,
- as predicted for SB407 in 2003, and
- actual SB407 from 2005 tax returns.

Figure 4, which shows all tax brackets, shows what happened to high-income taxpayers well. But 95% of taxpayers are in the area to the left of $110,000 of household income. To better show what happened to these taxpayers, Figure 5 shows only the brackets with incomes less than $110,000.

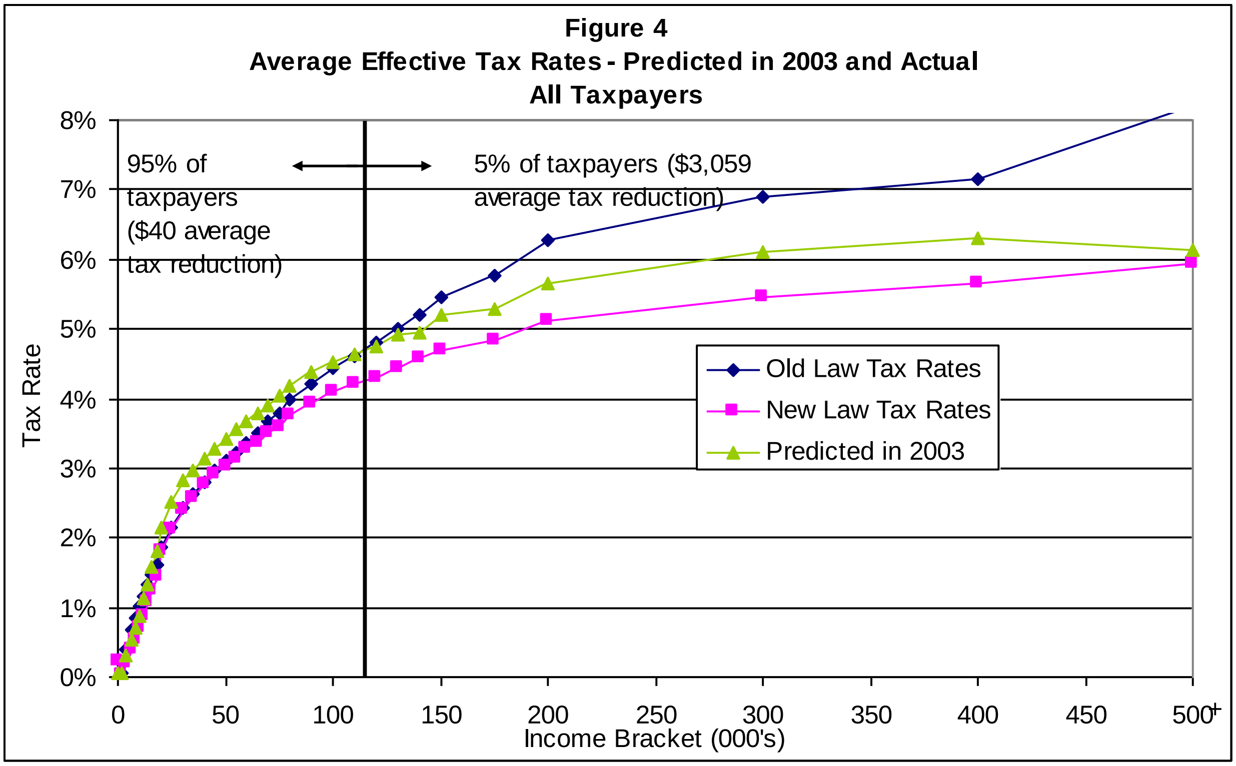


Figure 4
Average Effective Tax Rates - Predicted in 2003 and Actual
All Taxpayers
95% of taxpayers ($40 average tax reduction)
5% of taxpayers ($3,059 average tax reduction)
Old Law Tax Rates
New Law Tax Rates
Predicted in 2003
Tax Rate
Income Bracket (000's)
0%
1%
2%
3%
4%
5%
6%
7%
8%
0
50
100
150
200
250
300
350
400
450
500+

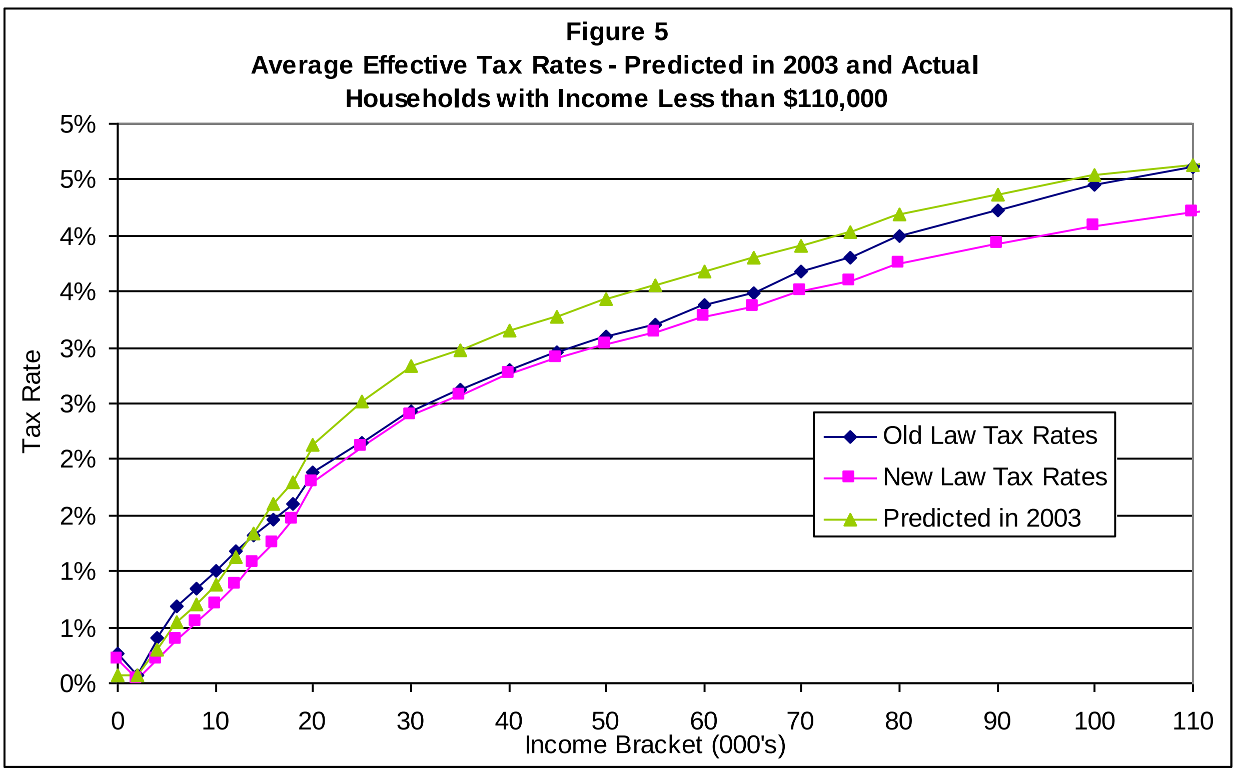


Figure 5
Average Effective Tax Rates - Predicted in 2003 and Actual
Households with Income Less than $110,000
Old Law Tax Rates
New Law Tax Rates
Predicted in 2003
Tax Rate
Income Bracket (000's)
0%
1%
1%
2%
2%
3%
3%
4%
4%
5%
5%
0
10
20
30
40
50
60
70
80
90
100
110

Winners and Losers

Not all taxpayers received a tax cut because of SB407. The rate table changes reduced the marginal rate at most taxable income levels but increased it in some ranges. The capital gains tax credit reduced taxes for those taxpayers who have capital gains income, but only 17% of households reported positive capital gains for 2005. The cap on the itemized deduction for federal income taxes increases Montana income tax for those taxpayers who itemize deductions and paid federal income taxes that were more than the cap.

In most income brackets, some taxpayers pay less with SB407, some pay more, and some have essentially "no change" in their tax liability. (To be consistent with the original analysis done during the 2003 session, taxpayers with a change in liability of less than $50, either up or down, are considered to have "no change" in their tax.)

Table 4, on the next page, shows the number of taxpayers in each income bracket with a tax reduction of more than $50, with a tax increase of more than $50, and with a change of less than $50 either way.

Table 4 Winners and Losers from SB 407							
Income Brackets		**Tax Reduction > $50**		**Tax Increase > $50**		**Change < $50**	
Income Range	**Number of Households in Bracket**	**Number of Households**	**% of Households in Bracket**	**Number of Households**	**% of Households in Bracket**	**Number of Households**	**% of Households in Bracket**
$ 0 - $ 1,999	13,549	27	0.2%	1	0.0%	13,521	99.8%
$ 2,000 - $ 3,999	17,822	14	0.1%	1	0.0%	17,807	99.9%
$ 4,000 - $ 5,999	18,096	19	0.1%	2	0.0%	18,075	99.9%
$ 6,000 - $ 7,999	17,239	267	1.5%	1	0.0%	16,971	98.4%
$ 8,000 - $ 9,999	16,723	1,997	11.9%	2	0.0%	14,724	88.0%
$ 10,000 - $ 11,999	16,095	6,981	43.4%	0	0.0%	9,114	56.6%
$ 12,000 - $ 13,999	15,301	6,758	44.2%	3	0.0%	8,540	55.8%
$ 14,000 - $ 15,999	14,825	3,370	22.7%	5	0.0%	11,450	77.2%
$ 16,000 - $ 17,999	14,645	2,713	18.5%	10	0.1%	11,922	81.4%
$ 18,000 - $ 19,999	13,799	2,289	16.6%	7	0.1%	11,503	83.4%
$ 20,000 - $ 24,999	29,860	4,504	15.1%	61	0.2%	25,295	84.7%
$ 25,000 - $ 29,999	24,717	3,979	16.1%	146	0.6%	20,592	83.3%
$ 30,000 - $ 34,999	21,401	3,705	17.3%	383	1.8%	17,313	80.9%
$ 35,000 - $ 39,999	18,447	4,190	22.7%	783	4.2%	13,474	73.0%
$ 40,000 - $ 44,999	16,572	4,364	26.3%	1,410	8.5%	10,798	65.2%
$ 45,000 - $ 49,999	14,713	4,650	31.6%	1,770	12.0%	8,293	56.4%
$ 50,000 - $ 54,999	13,603	4,975	36.6%	2,041	15.0%	6,587	48.4%
$ 55,000 - $ 59,999	12,312	5,007	40.7%	2,361	19.2%	4,944	40.2%
$ 60,000 - $ 64,999	11,223	4,809	42.8%	2,395	21.3%	4,019	35.8%
$ 65,000 - $ 69,999	9,832	4,557	46.3%	1,973	20.1%	3,302	33.6%
$ 70,000 - $ 74,999	8,699	4,408	50.7%	1,694	19.5%	2,597	29.9%
$ 75,000 - $ 79,999	7,549	4,280	56.7%	1,293	17.1%	1,976	26.2%
$ 80,000 - $ 89,999	11,930	7,500	62.9%	2,166	18.2%	2,264	19.0%
$ 90,000 - $ 99,999	8,388	5,775	68.8%	1,541	18.4%	1,072	12.8%
$100,000 - $109,999	5,670	4,150	73.2%	990	17.5%	530	9.3%
$110,000 - $119,999	4,092	3,015	73.7%	752	18.4%	325	7.9%
$120,000 - $129,999	2,965	2,297	77.5%	471	15.9%	197	6.6%
$130,000 - $139,999	2,210	1,752	79.3%	320	14.5%	138	6.2%
$140,000 - $149,999	1,680	1,390	82.7%	229	13.6%	61	3.6%
$150,000 - $174,999	2,957	2,491	84.2%	389	13.2%	77	2.6%
$175,000 - $199,999	1,856	1,614	87.0%	206	11.1%	36	1.9%
$200,000 - $299,999	3,585	3,171	88.5%	363	10.1%	51	1.4%
$300,000 - $399,999	1,353	1,235	91.3%	105	7.8%	13	1.0%
$400,000 - $499,999	709	644	90.8%	61	8.6%	4	0.6%
$500,000+	1,567	1,468	93.7%	91	5.8%	8	0.5%
TOTALS	**395,984**	**114,365**	**28.9%**	**24,026**	**6.1%**	**257,593**	**65.1%**

Twenty-nine percent of households had a tax reduction of at least $50. In general, the percentage of households with tax liability at least $50 lower with SB407 is higher at higher incomes. It increases from essentially 0% in the lowest income brackets to 93.7% in the highest. The only exception to the steady increase in the percent of households with a reduction as income rises is between $10,000 and $20,000. Households in this income range benefited from the drop in the lowest tax rate from 2% to 1%.

Above $75,000 of income, a majority of taxpayers had a tax decrease. Below $75,000 of household income, a majority of taxpayers had no change or a tax increase.

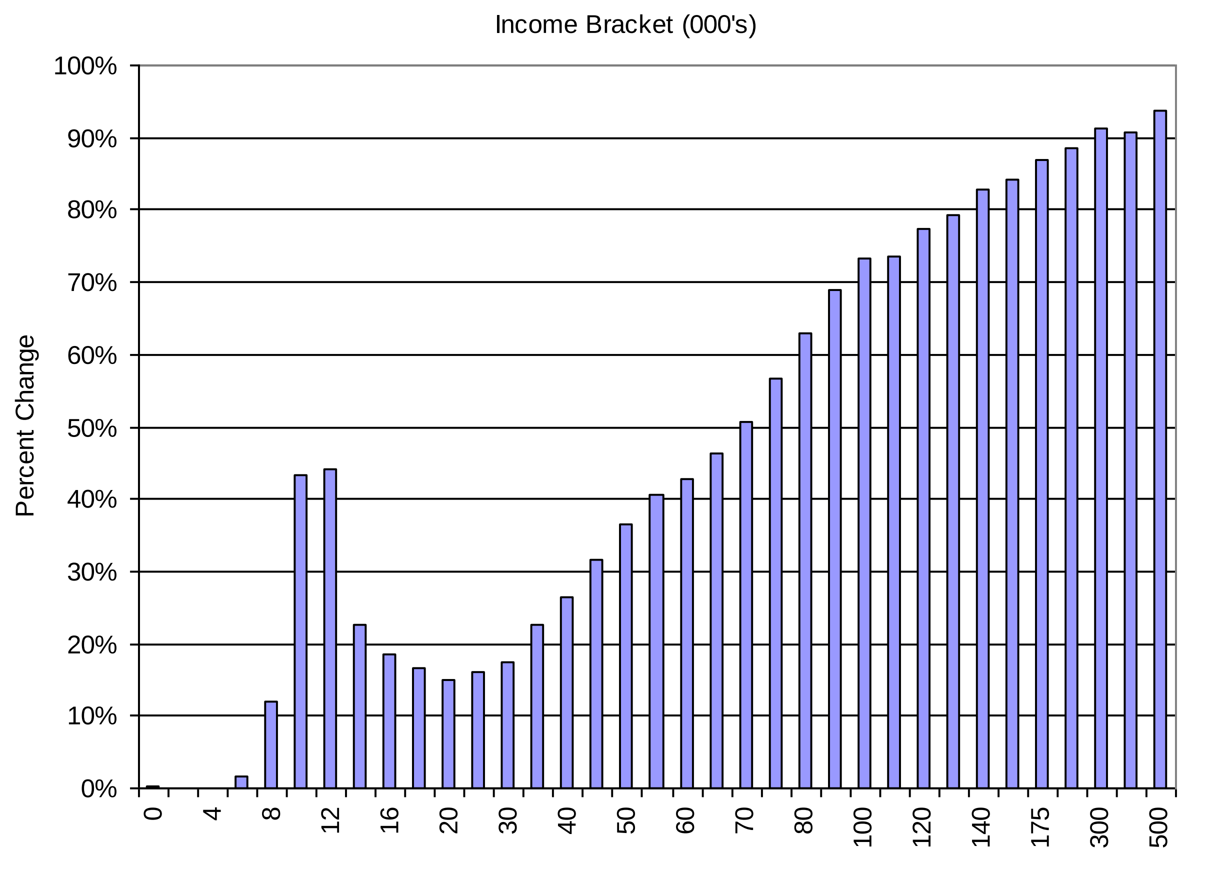
Six percent of households paid at least $50 more with SB407. The percentage paying at least $50 more is highest at 21.0% for the $60,000 to $65,000 income bracket. From this point, the percentage paying at least $50 more generally decreases as income either rises or falls, but averages 10% or more for households in all income brackets between $45,000 and $300,000.

Sixty-five percent of households saw a change in tax liability of less than $50. This percentage decreases from essentially 100% of households with the lowest incomes to less than 1% of households with the highest incomes.

These figures are very close to the original 2003 estimates which forecast that 27% of households would have a tax reduction of $50 or more; 6.4% of households would have a tax increase of $50 or more; and 67% of households would have "no change".

Figure 6 shows the percent of households in each income bracket with a tax reduction of at least $50.

Figure 6
Percent of Households with Reduction in Tax Liability
Old Law to SB407 - TY2005



Revenue Impacts of SB 407

Executive Summary

The 2003 legislature passed SB 407. This bill reduced income tax rates, capped the itemized deduction for federal taxes, and provided a credit equal to 2% of capital gains income. It also imposed new taxes on lodging and rental cars and increased taxes on cigarettes and tobacco products.

The fiscal note for SB 407 estimated that the net reduction in general fund revenue for FY 2008 would be about $17 million. The actual net revenue reduction for FY 2009 was $43.9 million.

Revenue from the new taxes and excise tax increases in SB 407 is about what was predicted in 2003. The reduction in income tax revenue is much larger than predicted, largely because

- Income is higher than was predicted,
- Capital gains income is higher than was predicted,
- Income growth after 2003 went disproportionately to higher income taxpayers, who received the largest percentage tax cuts from SB 407, and
- The cap on the deduction for federal income tax limited the revenue windfall the state received from federal tax cuts.

High and low income taxpayers received the highest percentage reductions in income tax liability. The average reduction was less than 2% for taxpayers with incomes between $30,000 and $80,000. It was more than 10% for taxpayers with incomes less than $20,000 or more than $200,000.

More than half the reduction in income taxes went to taxpayers with income over $500,000.

Introduction and Summary

The 2003 Legislature passed SB 407, which reduced income tax rates, capped the itemized deduction for federal taxes at $5,000 ($10,000 for a joint return), and provided a credit for a percentage of capital gains income (1% in 2005 and 2006 and 2% beginning in 2007). SB 407 also raised taxes on cigarettes and other tobacco products and imposed new taxes on lodging and rental cars.

In 2006, the Department of Revenue analyzed the impacts of SB 407. This paper updates and expands that analysis using information from 2008 income tax returns.

The first section explains the changes that SB 407 made to the individual income tax and other taxes.

The second section presents estimates of the reductions in 2008 income tax liability for full year resident taxpayers, both in total and by income group. For each group, it also shows the percentage change in tax liability and the change in average effective tax rate.

The third section presents estimates of the number and percentage of winners and losers in each income group, where winners and losers are defined in terms of having 2% lower or 2% higher income tax liability.

The final section looks at the net revenue impact of SB 407. It gives estimates of the reduction in income tax revenue and the revenue from the increases in lodging, rental car, cigarette, and tobacco taxes. It looks at reasons why the net revenue reduction has been larger than was predicted in 2003 and looks at how the impact of SB 407 may change in the next several years.

SB 407

SB 407 reduced income tax rates, imposed two new selective sales taxes, and increased taxes on cigarettes and other tobacco products. During the 2003 session, it was estimated that the net effect on state revenue would be close to zero in FY 2006 but that there would be increasing revenue losses in later fiscal years.

SB 407 reduced the number of income tax rates, lowered the top and bottom rates, and made rate brackets much narrower. It also capped the itemized deduction for federal income taxes at $5,000 ($10,000 for a married couple filing a joint return), and created a new non-refundable credit equal to 2% of a taxpayer's capital gains income. This new credit is equivalent to taxing capital gains at a lower rate than ordinary income.

Table 1 shows the income tax changes in SB 407.

Table 1
Income Tax Provisions of SB 407

Income Tax Rates
Brackets Adjusted for Inflation to 2008

Old Law: Taxable Income	Old Law: Marginal Tax Rate	SB 407: Taxable Income	SB 407: Marginal Tax Rate
$0 to $2,700	2.0%	$0 to $2,600	1.0%
$2,701 to $5,300	3.0%	$2,601 to $4,600	2.0%
$5,301 to $10,600	4.0%	$4,601 to $7,000	3.0%
$10,601 to $15,900	5.0%	$7,001 to $9,500	4.0%
$15,901 to $21,200	6.0%	$9,501 to $12,200	5.0%
$21,201 to $26,500	7.0%	$12,201 to $15,600	6.0%
$26,501 to $37,100	8.0%	Over $15,600	6.9%
$37,101 to $53,100	9.0%		
$53,101 to $92,900	10.0%		
Over $92,900	11.0%		

Deduction for Federal Income Taxes

Old Law	SB 407
Itemized deduction allowed for full amount of federal income tax paid during year.	Deduction limited to $5,000 ($10,000 for joint return).

Taxation of Capital Gains Income

Old Law	SB 407
Same as ordinary income.	Credit equal to 2% of capital gains income.

Table 2 shows the new taxes and the increases in cigarette and tobacco taxes.

Table 2
Other Tax Provisions of SB 407

Accommodations	New 3% sales tax
Rental Cars	New 4% sales tax
Cigarettes	Increased tax rate by $0.52 per pack
Other Tobacco Products	Increased tax rate from 12.5% to 25% (rate for moist snuff expressed in cents/ounce)

These new taxes and tax increases were imposed beginning in 2003, while the income tax changes went into effect in 2005, with the capital gains credit going from 1% to 2% in 2007. SB 407 was expected to result in net revenue increases in FY 2003 through FY 2005, be close to revenue neutral in FY 2006, and to result in net revenue decreases in later fiscal years.

Income Tax Revenue Reduction

Tax liability for 2008 was calculated for all timely-filed full year resident returns under current law and under the law as it existed before SB 407. Table 3, on the next page, shows the total change in tax liability and the change for thirty-five income groups. The left side of the table shows the range of income for each group, the number of households in the group, and the total income of these households. In this context, a household is defined as a married couple, filing either a joint return or separate returns on the same form, or an individual filing as single, head-of-household, or married with the spouse either filing on a separate form or not filing a return. Total household income is the sum of total income reported on the taxpayer's federal return and state additions to federal income. The right side of the table shows total tax liability of households in each group under pre-SB 407 law and under current law and the difference.

Table 4, on the following page, shows the changes in tax liability in the right-hand column of Table 3 as a percent of pre-SB 407 tax liability and as the average change per household. It also shows the average effective tax rate, which is tax liability divided by total household income, under the old law and under current law.

Table 3
Impact of SB 407 on Full-Year Resident's 2008 Income Tax

	Income Brackets		Tax Liability of Households in Bracket		
Income Range	Number of Households in Bracket	Total Income of Households in Bracket	Old Law	SB 407	Difference Due to SB 407
$ 0 - $ 1,999	14,398	$14,188,170	$1,350	$568	-$782
$ 2,000 - $ 3,999	16,895	51,055,669	128,540	63,118	-65,422
$ 4,000 - $ 5,999	17,661	88,147,148	462,625	239,991	-222,633
$ 6,000 - $ 7,999	16,794	117,280,013	870,358	507,505	-362,854
$ 8,000 - $ 9,999	16,059	144,576,885	1,306,423	841,857	-464,566
$ 10,000 - $ 11,999	15,554	170,937,665	1,693,420	1,169,297	-524,122
$ 12,000 - $ 13,999	15,273	198,426,889	2,195,964	1,629,510	-566,454
$ 14,000 - $ 15,999	14,706	220,531,089	2,759,927	2,170,382	-589,545
$ 16,000 - $ 17,999	14,483	246,138,801	3,392,557	2,813,535	-579,021
$ 18,000 - $ 19,999	14,083	267,441,258	4,043,593	3,517,560	-526,033
$ 20,000 - $ 24,999	32,019	717,573,586	12,555,431	11,661,593	-893,839
$ 25,000 - $ 29,999	27,247	747,589,458	14,990,597	14,634,714	-355,884
$ 30,000 - $ 34,999	23,197	752,200,482	17,099,356	16,910,410	-188,946
$ 35,000 - $ 39,999	20,269	759,034,226	18,492,156	18,315,272	-176,885
$ 40,000 - $ 44,999	17,862	758,148,246	19,373,501	19,231,036	-142,464
$ 45,000 - $ 49,999	16,143	765,941,603	20,656,203	20,632,595	-23,608
$ 50,000 - $ 54,999	14,721	772,451,949	21,540,018	21,509,026	-30,992
$ 55,000 - $ 59,999	13,736	789,165,831	22,955,846	22,874,354	-81,492
$ 60,000 - $ 64,999	12,340	770,829,411	22,906,790	22,771,111	-135,679
$ 65,000 - $ 69,999	11,314	763,080,532	23,580,031	23,294,272	-285,758
$ 70,000 - $ 74,999	10,303	746,221,434	23,851,995	23,527,030	-324,965
$ 75,000 - $ 79,999	9,177	710,926,944	23,737,640	23,293,393	-444,247
$ 80,000 - $ 89,999	15,578	1,320,470,093	46,218,032	45,060,738	-1,157,295
$ 90,000 - $ 99,999	11,488	1,088,065,205	40,405,398	39,146,947	-1,258,451
$100,000 - $109,999	8,651	905,930,223	35,207,595	34,163,418	-1,044,177
$110,000 - $119,999	6,170	707,960,211	28,896,963	27,762,444	-1,134,519
$120,000 - $129,999	4,510	562,351,003	23,700,569	22,760,017	-940,553
$130,000 - $139,999	3,210	432,563,957	18,897,031	18,066,993	-830,038
$140,000 - $149,999	2,410	348,945,462	15,842,359	14,962,435	-879,924
$150,000 - $174,999	4,207	679,109,982	32,258,974	29,982,857	-2,276,116
$175,000 - $199,999	2,555	477,058,411	24,173,219	22,008,771	-2,164,448
$200,000 - $299,999	4,531	1,083,103,605	58,878,584	52,186,555	-6,692,029
$300,000 - $399,999	1,659	570,088,687	34,243,577	29,334,079	-4,909,499
$400,000 - $499,999	843	376,344,684	23,316,363	20,041,962	-3,274,401
$500,000 +	1,829	2,439,137,383	168,670,538	129,559,207	-39,111,332
Totals	431,875	$21,563,016,195	$809,303,523	$736,644,551	-$72,658,972

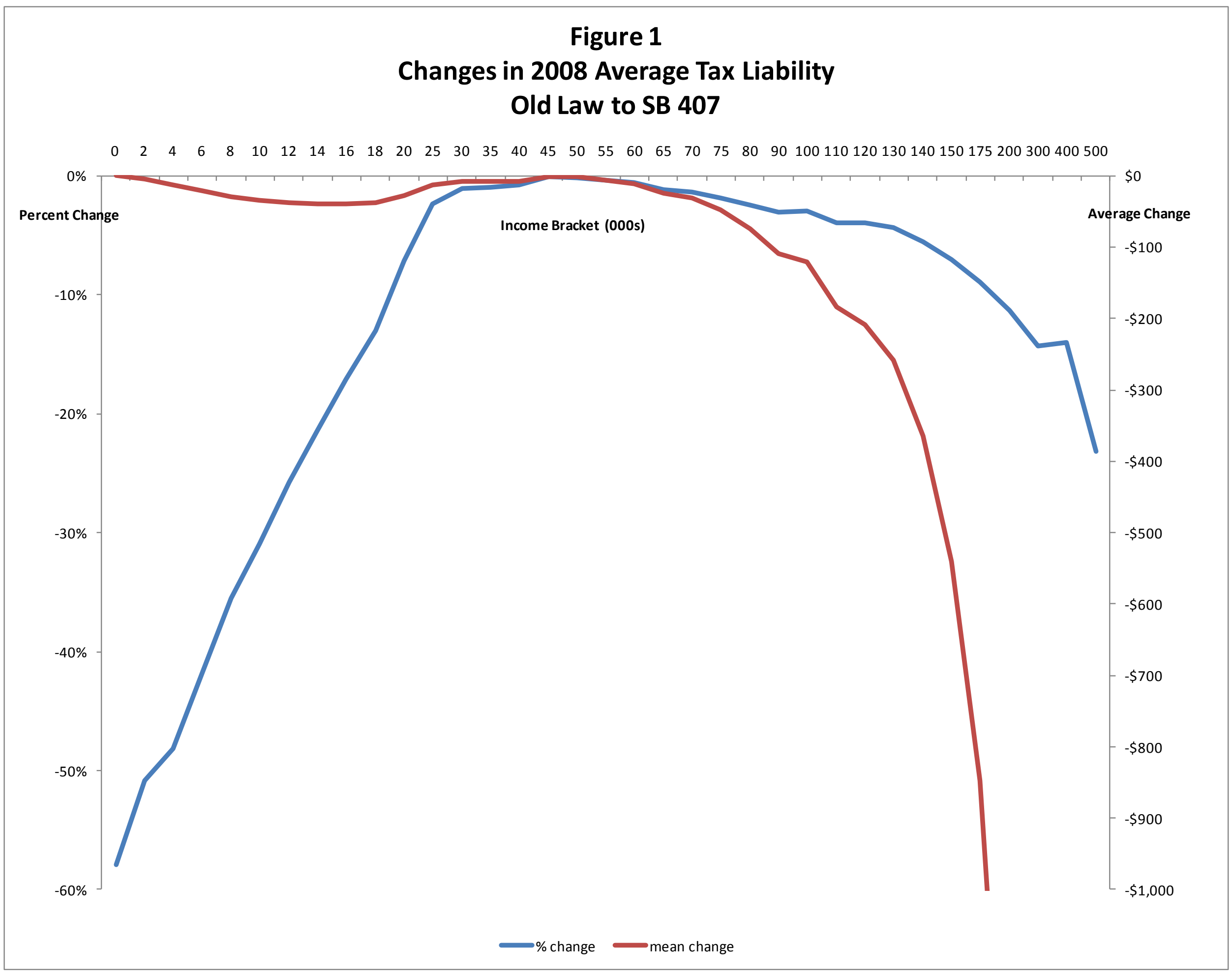
Table 4
Impact of SB 407 on Full-Year Resident's 2008 Income Tax

	Change in Tax Liability		Average Effective Tax Rate	
Income Range	Percent Change	Average Change	Old Law	SB 407
$ 0 - $ 1,999	-58.0%	-$0.05	0.01%	0.00%
$ 2,000 - $ 3,999	-50.9%	-3.87	0.25%	0.12%
$ 4,000 - $ 5,999	-48.1%	-12.61	0.52%	0.27%
$ 6,000 - $ 7,999	-41.7%	-21.61	0.74%	0.43%
$ 8,000 - $ 9,999	-35.6%	-28.93	0.90%	0.58%
$ 10,000 - $ 11,999	-31.0%	-33.70	0.99%	0.68%
$ 12,000 - $ 13,999	-25.8%	-37.09	1.11%	0.82%
$ 14,000 - $ 15,999	-21.4%	-40.09	1.25%	0.98%
$ 16,000 - $ 17,999	-17.1%	-39.98	1.38%	1.14%
$ 18,000 - $ 19,999	-13.0%	-37.35	1.51%	1.32%
$ 20,000 - $ 24,999	-7.1%	-27.92	1.75%	1.63%
$ 25,000 - $ 29,999	-2.4%	-13.06	2.01%	1.96%
$ 30,000 - $ 34,999	-1.1%	-8.15	2.27%	2.25%
$ 35,000 - $ 39,999	-1.0%	-8.73	2.44%	2.41%
$ 40,000 - $ 44,999	-0.7%	-7.98	2.56%	2.54%
$ 45,000 - $ 49,999	-0.1%	-1.46	2.70%	2.69%
$ 50,000 - $ 54,999	-0.1%	-2.11	2.79%	2.78%
$ 55,000 - $ 59,999	-0.4%	-5.93	2.91%	2.90%
$ 60,000 - $ 64,999	-0.6%	-11.00	2.97%	2.95%
$ 65,000 - $ 69,999	-1.2%	-25.26	3.09%	3.05%
$ 70,000 - $ 74,999	-1.4%	-31.54	3.20%	3.15%
$ 75,000 - $ 79,999	-1.9%	-48.41	3.34%	3.28%
$ 80,000 - $ 89,999	-2.5%	-74.29	3.50%	3.41%
$ 90,000 - $ 99,999	-3.1%	-109.54	3.71%	3.60%
$100,000 - $109,999	-3.0%	-120.70	3.89%	3.77%
$110,000 - $119,999	-3.9%	-183.88	4.08%	3.92%
$120,000 - $129,999	-4.0%	-208.55	4.21%	4.05%
$130,000 - $139,999	-4.4%	-258.58	4.37%	4.18%
$140,000 - $149,999	-5.6%	-365.11	4.54%	4.29%
$150,000 - $174,999	-7.1%	-541.03	4.75%	4.42%
$175,000 - $199,999	-9.0%	-847.14	5.07%	4.61%
$200,000 - $299,999	-11.4%	-1,476.94	5.44%	4.82%
$300,000 - $399,999	-14.3%	-2,959.31	6.01%	5.15%
$400,000 - $499,999	-14.0%	-3,884.22	6.20%	5.33%
$500,000 +	-23.2%	-21,384.00	6.92%	5.31%
Totals	-9.0%	-$168.24	3.75%	3.42%

The percentage reduction in tax liability is smallest in the middle of the income distribution. It is 1% or less for households with income between $35,000 and $65,000. The percentage reduction is much higher for low- and high-income households. It is more than 10% for households with income less than $20,000 or more than $200,000.

The average reduction per household shows a more complicated pattern. It is lowest for the lowest income group, where most households have no tax liability under either old law or current law. The average reduction per household increases up to about $40 at $16,000 of household income and then decreases to about $1 at $45,000 to $50,000 of household income. It then rises steadily with income, to more than $21,000 for households with income over $500,000.

Figure 1 shows this information graphically. The blue line, plotted against the left-hand axis, shows the percentage change for each income group. The red line, plotted against the right-hand axis, shows the average dollar change for each group. The right-hand axis is truncated at $1,000 to show the variation at lower income levels.



Average effective tax rates are lower for all income groups under SB 407 than under current law, but the differences follow a pattern that is similar to the pattern of percentage difference in tax liability. The difference is tiny, 1/100th of a percent, for the lowest income group, increases up to about $10,000 of income, and then decreases up to about $45,000 of income. Between $45,000 and $55,000 of income, the difference is 1/100th of a percent, and then increases with income, up to the highest income group, where the difference is 1.6 percentage points.

Figures 2 and 3 show average effective tax rates. Figure 2 shows average effective tax rates under old law and current law for all income groups. It shows that the difference in average effective tax rates is small up to about $150,000 of income and widens as income increases beyond that point. Under old law, the highest income group, with income over $500,000, had a significantly higher average effective tax rate than other taxpayers. Under current law, the group with income between $400,000 and $500,000 has the highest average effective tax rate, and the highest income group has a slightly lower average effective tax rate.

Figure 2
Average Effective Tax Rates

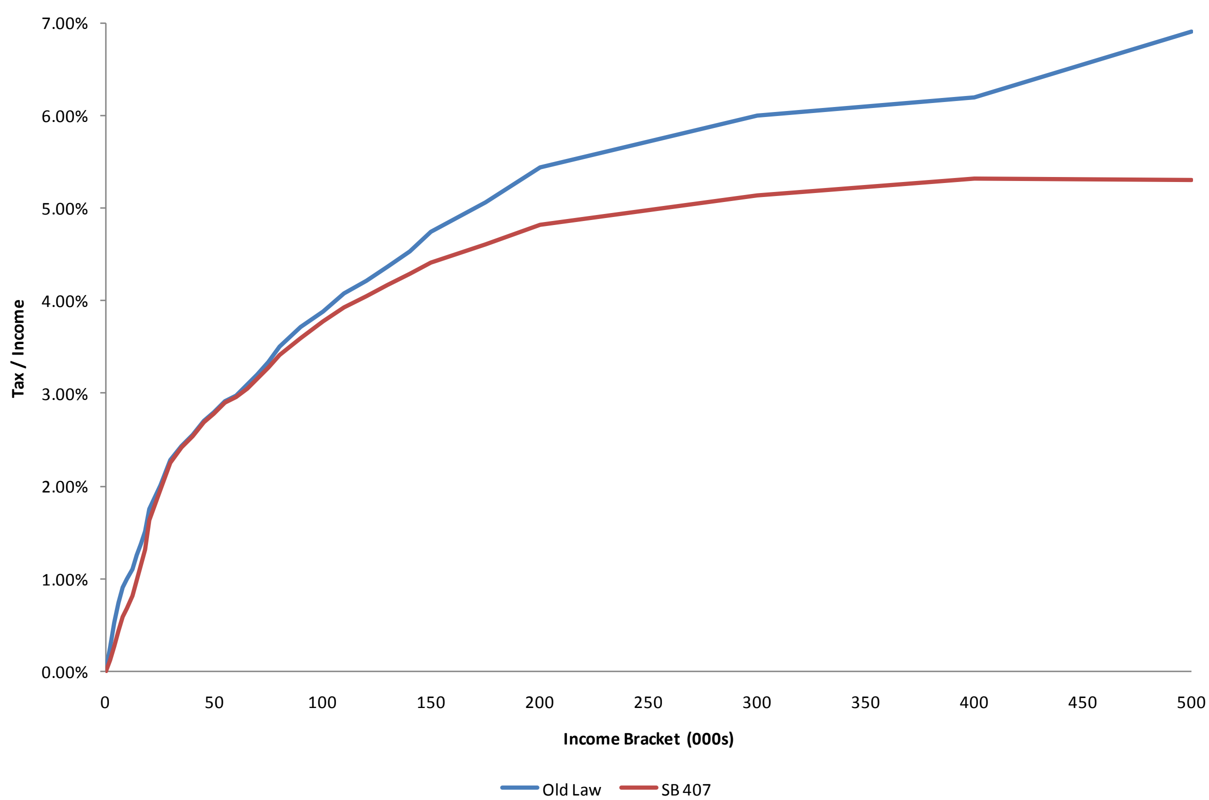
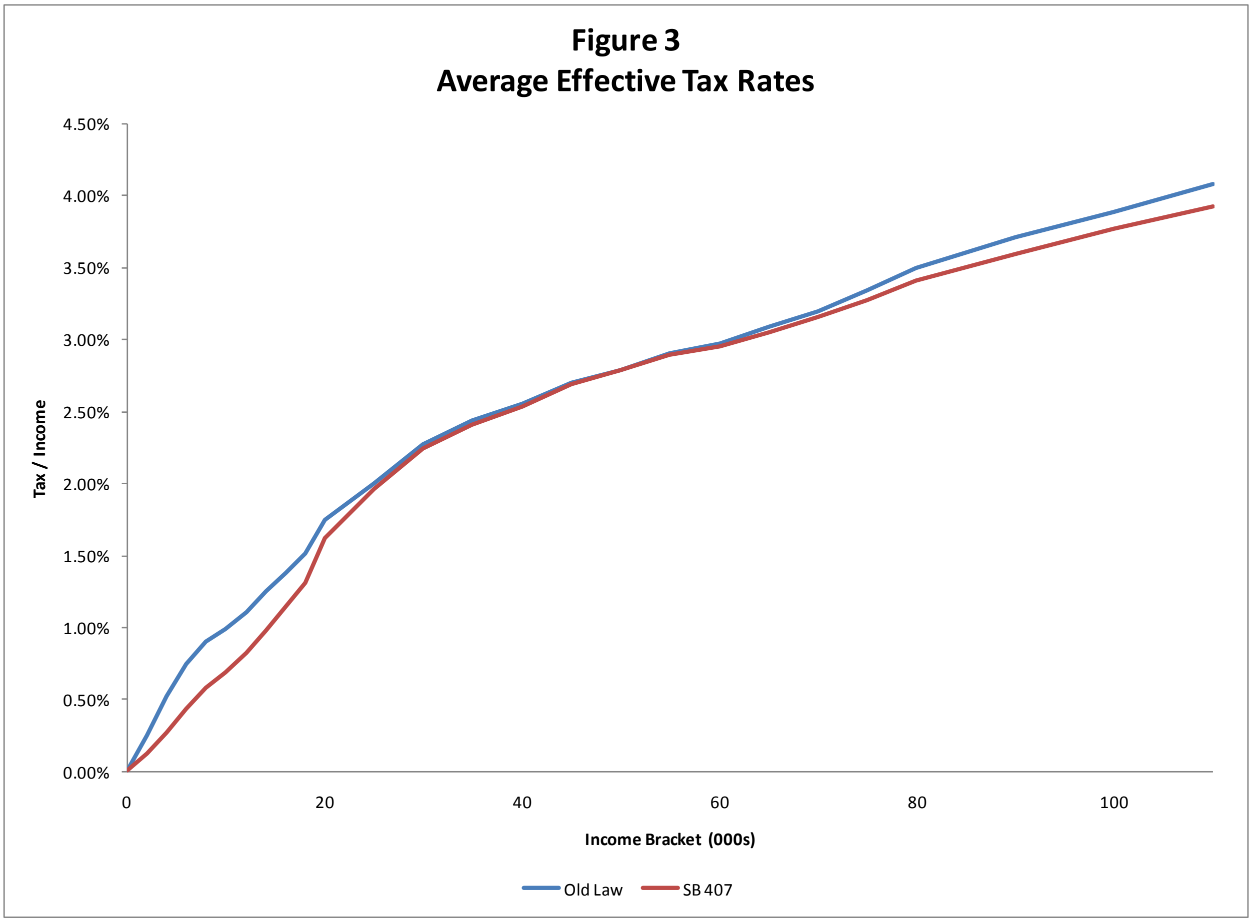


Figure 3 shows average effective tax rates for taxpayers with incomes of $110,000 or less. This includes 93% of households with 64% of total income. Figure 3 shows the very small difference in average effective tax rates for households with incomes between $30,000 and $65,000.



Tables 5 and 6 show some of the same information with households divided into only five income groups. The boundaries between groups are \$20,000, \$65,000, \$150,000, and \$500,000 of income.

The first three columns of Table 5 show the five income ranges and the number and percent of households in each group. The next two column show the income reported by each group and each group's percent of the total. The four right-hand columns show total tax liability for each group and each group's percent of total tax liability under pre-SB 407 law and under current law.

Table 5
Impact of SB 407 on Full-Year Resident's 2008 Income Tax

	Households		Income		Old Law Tax		Current Law Tax	
Income Range	Number	%	$	%	$	%	$	%
$ 0 - $ 19,999	155,906	36.1%	$1,518,723,587	7.0%	$16,854,757	2.1%	$12,953,324	1.8%
$ 20,000 - $ 64,999	177,534	41.1%	$6,832,934,792	31.7%	$170,569,898	21.1%	$168,540,110	22.9%
$ 65,000 - $149,999	82,811	19.2%	$7,586,515,064	35.2%	$280,337,613	34.6%	$272,037,686	36.9%
$150,000 - $499,999	13,795	3.2%	$3,185,705,369	14.8%	$172,870,717	21.4%	$153,554,223	20.8%
$500,000 +	1,829	0.4%	$2,439,137,383	11.3%	$168,670,538	20.8%	$129,559,207	17.6%
Totals	431,875		$21,563,016,195		$809,303,523		$736,644,551	

The two highest income groups had 3.6% of households but 26.1% of income . While SB 407 reduced tax liability for all groups, the share of liability increased for each of the lower three income groups and decreased for both of the higher income groups. The top two groups' share of liability would have been 42.2% under the pre-SB 407 law but was actually 38.4%.

Table 6 repeats the information on number of households and old-law tax for each group and shows each group's tax reduction from SB 407. The third column from the right shows the total tax liability reduction for each group. The next column shows the percentage that reduction is of the group's old-law tax, and the right-hand column shows each group's share of the total reduction. For example, the middle income group had a total tax reduction of $8.3 million, which as 3.0% of their old-law tax liability and 11.4% of the total reduction for all taxpayers.

Table 6
Impact of SB 407 on Full-Year Resident's 2008 Income Tax

	Households		Old Law Tax		Tax Reduction		
Income Range	Number	%	$	%	$	Average % Reduction	% of Total Reduction
$ 0 - $ 19,999	155,906	36.1%	$16,854,757	2.1%	-$3,901,433	-23.1%	5.4%
$ 20,000 - $ 64,999	177,534	41.1%	$170,569,898	21.1%	-$2,029,787	-1.2%	2.8%
$ 65,000 - $149,999	82,811	19.2%	$280,337,613	34.6%	-$8,299,927	-3.0%	11.4%
$150,000 - $499,999	13,795	3.2%	$172,870,717	21.4%	-$19,316,493	-11.2%	26.6%
$500,000 +	1,829	0.4%	$168,670,538	20.8%	-$39,111,332	-23.2%	53.8%
Totals	431,875		$809,303,523		-$72,658,972	-9.0%	

The highest and lowest income groups had the largest percentage reductions, with both being over 23%. The groups with income between $20,000 and $150,000 had much smaller percentage reductions.

Each group's share of the total tax reduction reflects the combination of its share of old-law tax liability and its percentage reduction. The highest income group had about one-fifth of tax liability under old law, but because it had the highest percentage tax reduction, it received over half of the total reduction. The groups with income between $20,000 and $150,000 had over half of old-law tax liability, but because their percentage reductions were so small, they received about one-seventh of the total reduction.

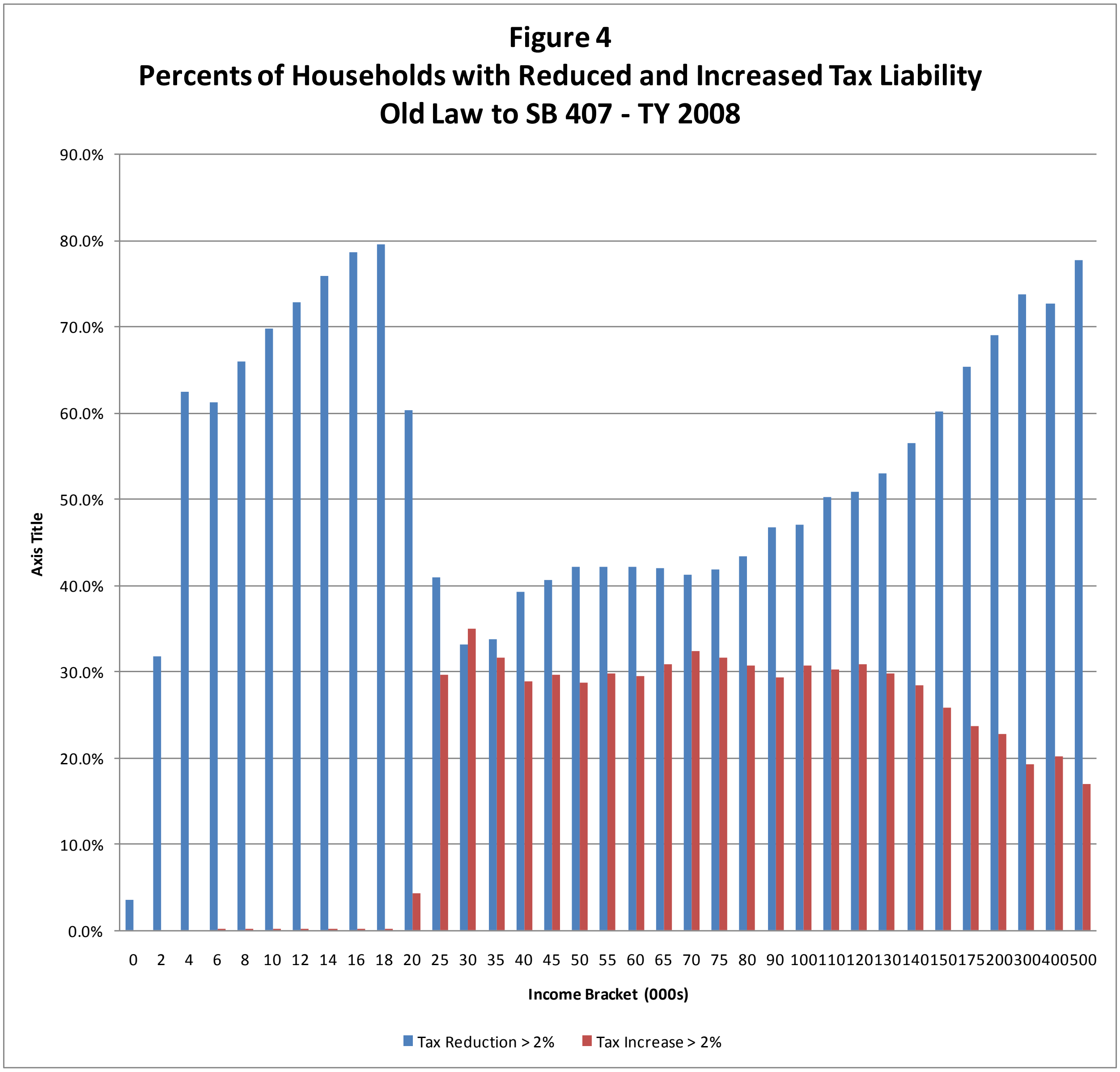
Winners and Losers

Taxpayers with similar incomes were not necessarily affected the same by SB 407. Table 7 shows, for each of the 35 income groups, the number and percent of households with a tax reduction of more than 2%, with a tax increase of more than 2%, and with a change of less than 2%.

Table 7
Taxpayers with Higher and Lower Taxes from SB 407

Income Brackets		Tax Reduction > 2%		Tax Increase > 2%		Change < 2%	
Income Range	Number of Households in Bracket	Number of Households	% of Households in Bracket	Number of Households	% of Households in Bracket	Number of Households	% of Households in Bracket
$ 0 - $ 1,999	14,398	515	3.6%	0	0.0%	13,883	96.4%
$ 2,000 - $ 3,999	16,895	5,371	31.8%	0	0.0%	11,524	68.2%
$ 4,000 - $ 5,999	17,661	11,027	62.4%	0	0.0%	6,634	37.6%
$ 6,000 - $ 7,999	16,794	10,298	61.3%	1	0.0%	6,495	38.7%
$ 8,000 - $ 9,999	16,059	10,604	66.0%	10	0.1%	5,445	33.9%
$ 10,000 - $ 11,999	15,554	10,861	69.8%	10	0.1%	4,683	30.1%
$ 12,000 - $ 13,999	15,273	11,127	72.9%	9	0.1%	4,137	27.1%
$ 14,000 - $ 15,999	14,706	11,171	76.0%	23	0.2%	3,512	23.9%
$ 16,000 - $ 17,999	14,483	11,383	78.6%	29	0.2%	3,071	21.2%
$ 18,000 - $ 19,999	14,083	11,202	79.5%	33	0.2%	2,848	20.2%
$ 20,000 - $ 24,999	32,019	19,303	60.3%	1,403	4.4%	11,313	35.3%
$ 25,000 - $ 29,999	27,247	11,146	40.9%	8,082	29.7%	8,019	29.4%
$ 30,000 - $ 34,999	23,197	7,697	33.2%	8,118	35.0%	7,382	31.8%
$ 35,000 - $ 39,999	20,269	6,850	33.8%	6,428	31.7%	6,991	34.5%
$ 40,000 - $ 44,999	17,862	7,003	39.2%	5,148	28.8%	5,711	32.0%
$ 45,000 - $ 49,999	16,143	6,562	40.6%	4,792	29.7%	4,789	29.7%
$ 50,000 - $ 54,999	14,721	6,212	42.2%	4,237	28.8%	4,272	29.0%
$ 55,000 - $ 59,999	13,736	5,800	42.2%	4,098	29.8%	3,838	27.9%
$ 60,000 - $ 64,999	12,340	5,205	42.2%	3,650	29.6%	3,485	28.2%
$ 65,000 - $ 69,999	11,314	4,758	42.1%	3,498	30.9%	3,058	27.0%
$ 70,000 - $ 74,999	10,303	4,258	41.3%	3,342	32.4%	2,703	26.2%
$ 75,000 - $ 79,999	9,177	3,840	41.8%	2,901	31.6%	2,436	26.5%
$ 80,000 - $ 89,999	15,578	6,767	43.4%	4,793	30.8%	4,018	25.8%
$ 90,000 - $ 99,999	11,488	5,379	46.8%	3,371	29.3%	2,738	23.8%
$100,000 - $109,999	8,651	4,072	47.1%	2,658	30.7%	1,921	22.2%
$110,000 - $119,999	6,170	3,101	50.3%	1,871	30.3%	1,198	19.4%
$120,000 - $129,999	4,510	2,293	50.8%	1,396	31.0%	821	18.2%
$130,000 - $139,999	3,210	1,701	53.0%	955	29.8%	554	17.3%
$140,000 - $149,999	2,410	1,363	56.6%	684	28.4%	363	15.1%
$150,000 - $174,999	4,207	2,530	60.1%	1,088	25.9%	589	14.0%
$175,000 - $199,999	2,555	1,669	65.3%	605	23.7%	281	11.0%
$200,000 - $299,999	4,531	3,125	69.0%	1,032	22.8%	374	8.3%
$300,000 - $399,999	1,659	1,224	73.8%	320	19.3%	115	6.9%
$400,000 - $499,999	843	613	72.7%	170	20.2%	60	7.1%
$500,000 +	1,829	1,422	77.7%	310	16.9%	97	5.3%
Totals	431,875	217,452	50.4%	75,065	17.4%	139,358	32.3%

Figure 4 shows the percent of households in each group with a decrease of more than 2% and the percent with an increase of more than 2%.



In the lowest two income groups, the majority of households had less than a 2% change from SB 407. In the groups with income between $4,000 and $25,000, over 60% of households had a tax reduction of at least 2%. In all be the highest of these groups, less than 1% of households had a tax increase of at least 2%, while in the highest of these groups about 4% had a 2% increase.

The groups with income between $25,000 and $150,000 all had about 30% of households with at least a 2% tax increase. Above $150,000 of income, the percent of households with a 2% increase steadily drops, to about 17% for the highest income group.

The percent of households with at least a 2% tax reduction is lowest, about 33%, for households with income between $30,000 and $40,000. For households with income between $40,000 and about $80,000, the percentage hovers around 40%. Above $80,000 of income, the percent with at least a 2% tax reduction rises steadily with income, to about 78% for the highest income group.

The percent of taxpayers with less than a 2% change generally decreases with income, from 96.4% for the lowest income group to 5.3% for the highest.

Net Revenue Impact

SB 407 was passed in the spring of 2003. It immediately imposed new taxes on lodging and rental cars and increased the taxes on cigarettes and other tobacco products. It did not change the income tax until 2005. The fiscal note prepared during the 2003 session indicates that SB 407 was expected to increase state revenue in FY 2003 through FY 2005, be approximately revenue neutral in FY 2006, and then to reduce state revenue in later years. The reduction was expected to be $17.0 million in FY 2008 and to grow over time.

The fiscal note estimated that income tax revenue would be $38.9 million lower in FY 2006 because of SB 407 and that the reduction would grow over time. Actual income tax revenue was $768.9 million for FY 2006 and $815.1 million for FY 2009. This is a 6.0% increase. Assuming that the reduction from SB 407 would have grown at the same rate as revenue, it would have been $41.2 million for FY 2009.

The income tax revenue estimating model was used to estimate revenue under the pre-SB 407 law and under current law for FY 2006 through FY 2013. For FY 2006 through FY 2008, the model was used to recalculate taxes for returns from tax years 2005 through 2008 as if SB 407 had not been in effect. For FY 2009 through FY 2013, the model was used to forecast future tax liability, with and without SB 407, using the growth assumptions in the 2009 legislative revenue estimate. Figure 5 shows full-year residents' tax liability for tax years 2005 through 2013, with and without SB 407. Table 8 shows the estimated difference in revenue due to SB 407 in each of those years.

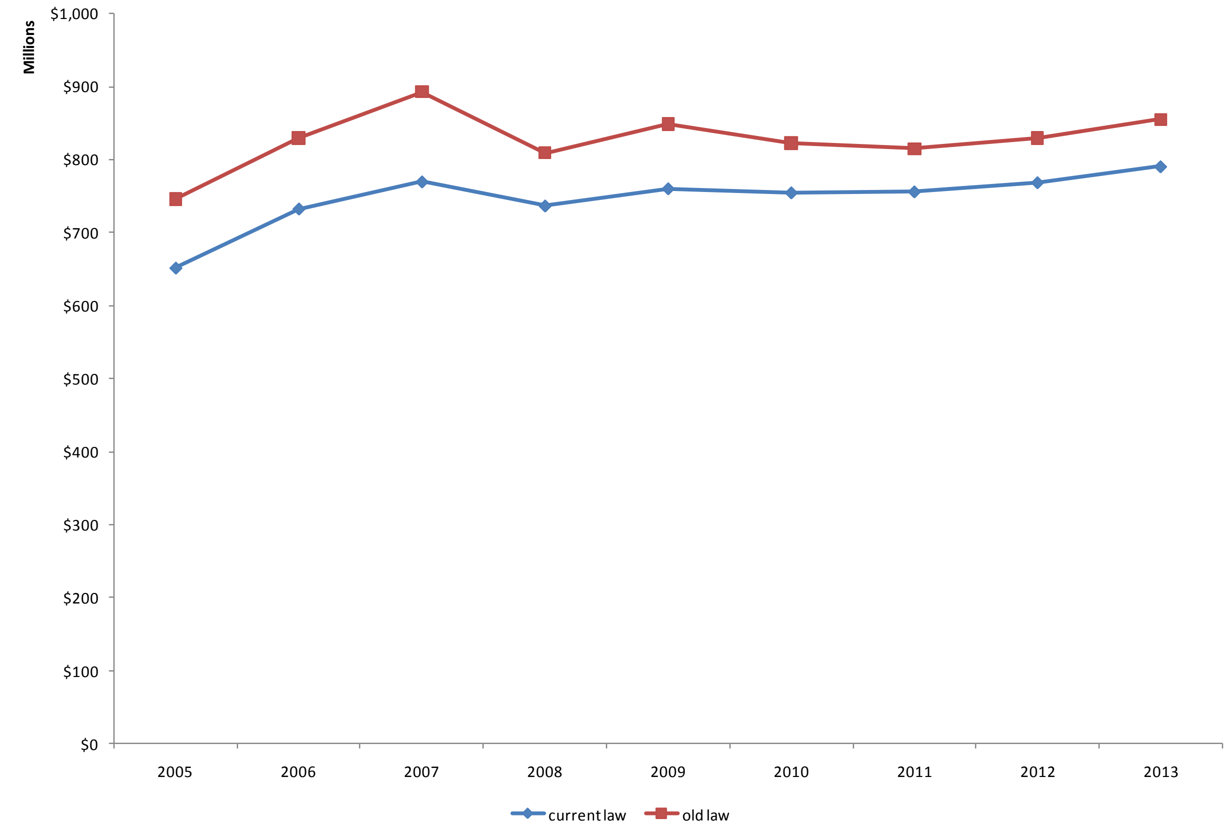


Figure 5
Full Year Resident Income Tax Liabilty
With and Without SB 407

Table 8
Estimated Income Tax Revenue Reductions from SB 407
FY 2009 to FY 2013

Fiscal Year	$ million
FY 2006	-$101.539
FY 2007	-$116.920
FY 2008	-$104.210
FY 2009	-$86.310
FY 2010	-$84.376
FY 2011	-$69.364
FY 2012	-$66.790
FY 2013	-$70.981

For FY 2006, the income tax revenue reduction is 2.6 times as large as estimated in the fiscal note. The estimated reduction increases in FY 2007, decreases each year from FY 2008 through FY 2012, and then increases again in FY 2013.

Table 9 compares the estimated income tax reduction for FY 2009 to actual revenue from the new taxes and tax increases in SB 407.

Table 9
FY 2009 Revenue Impact of SB 407
($ million)

Income Tax	-$86.3
Accomodations Sales Tax	$12.5
Rental Car Sales Tax	$2.9
Cigarette Tax ($0.52 of $1.70)	$24.4
Tobacco Tax (12.5% of 50%)	$2.6
Net Impact	-$43.9

The net revenue loss for FY 2009 is more than two-and-half times the FY 2007 net revenue loss estimated in the fiscal note. This difference is primarily from actual revenue being different from the 2003 predictions, rather than from growth between FY 2007 and FY 2009. Revenue from the accommodations sales tax and the tobacco tax increase are significantly higher than the FY 2005 estimates from the fiscal note. Revenue from the rental car sales tax is slightly higher, and revenue from the cigarette tax is lower. Overall, revenue from the new revenue sources in SB 407 is slightly higher than projected, but the loss in income tax revenue is much higher than projected.

A number of factors contributed to the fact that revenue reductions are larger than was predicted in 2003[1]. In 2005, Montana adjusted gross income was 16% higher than forecast. A larger tax base led to larger revenue reductions from rate cuts. In 2005, capital gains income was approximately twice what had been predicted in 2003. This made the revenue reduction from the capital gains credit much larger than predicted. Income growth from 2003 to 2005 went disproportionately to high-income taxpayers, who received larger-than-average percentage tax reductions from SB 407.

Between 2003 and 2005, Congress enacted several changes that reduced federal income taxes in 2005, particularly for higher income taxpayers. Under the old law, this would have resulted in a windfall for the state, as taxpayers with smaller deductions for federal taxes paid higher state taxes. With SB407, these federal tax changes did not affect state taxes for higher-income taxpayers whose deductions for federal taxes are capped. This made the state windfall from reduced federal taxes smaller than it would have been under old law.

One of the reasons that the revenue impact of SB 407 was smaller for 2008 than for 2005 was the fact that there was a jump in federal taxes paid in 2008. This appears to have been primarily from taxpayers who had under-paid during 2007 making payments

[1] For a full analysis, see "Explaining the Difference Between the Forecast and Actual Impacts of Senate Bill 407," Montana Department of Revenue, January 2007.

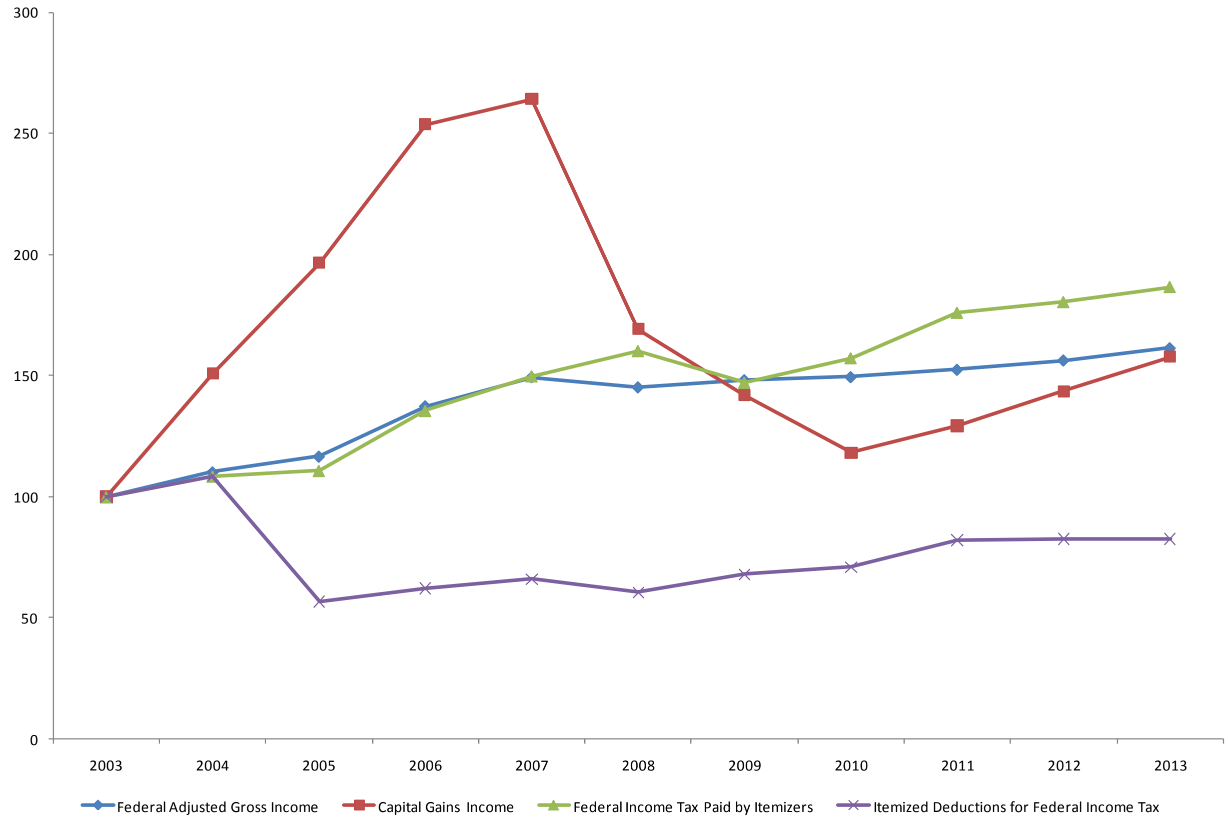
with their 2007 returns in the spring of 2008 and increasing their estimated payments for 2008. Another reason for the smaller impact in 2008 is that capital gains income was lower in 2008 than in 2005, and therefore the impact of the capital gains credit increasing from 1% to 2% was lower than it would have been.

Figure 6 shows actual and projected growth since 2003 in some of the more important factors affecting the fiscal impact of SB 407. It shows federal adjusted gross income, capital gains income, federal income tax paid by Montana taxpayers who itemized deductions, and itemized deductions for federal taxes, all as indexes with their 2003 values as the base. Thus, the index value for each series tells the ratio of the value in a later year to the value in 2003. For example, the index value for federal taxes in 2008 is 150, which means that federal taxes in 2008 were 150% of what they had been in 2003.

Income grew steadily and rapidly between 2003 and 2007, but growth is predicted to be much slower through 2013. The capital gains component of income grew dramatically from 2003 through 2007, but then dropped in 2008. It is forecast to drop again in 2009 and 2010 and then to grow more slowly through 2013.

Federal taxes are not growing in lock-step with income. The slower growth in 2005 reflects changes in federal law between 2003 and 2005 which included temporary tax reductions and acceleration of several tax reductions that had been passed in 2001 but were not scheduled to go into effect until later years. The divergence in 2008 reflects the extra payments made that year by high-income taxpayers who had underpaid in 2007. The gap between the indices for federal taxes and income beginning in 2011 is due to higher taxes when temporary tax reductions passed in 2001 through 2003 expire.

Figure 6
Growth Since 2003
Income, Capital Gains, Federal Taxes, Deductions for Federal Taxes
Indexed to 2003 = 100 (2003 - 2008 actual, 2009 - 2014 Forecast)



Total deductions for federal taxes do not follow federal taxes very closely. The large drop in 2005 is from the first year of the cap on the deduction. In 2008, when federal taxes increased, deductions for federal taxes actually fell, because the additional federal tax payments made in 2008 were mostly made by taxpayers whose deductions for federal taxes were capped. Deductions for federal taxes are forecast to increase much less than federal taxes in 2011 because much of the expected increase in federal taxes will go to taxpayers whose deduction is capped.

The cap on the deduction for federal taxes appears to have somewhat insulated state revenue from changes in federal taxes. The state missed out on a revenue windfall from federal tax reductions in 2005 but will also miss a large revenue hit from federal tax increases in 2011.

The falling income tax revenue reduction appears to be due largely to falling capital gains income in 2008 through 2010, high federal income tax payments in 2008, and federal income tax increases in 2011.