

INDIVIDUAL INCOME TAX

Revenue Description

Title 15, chapter 30, MCA, imposes a graduated individual income tax on gross income less exemptions and deductions. A taxpayer's Montana adjusted gross income is based on their federal adjusted gross income but may be higher or lower because some types of income are taxed by one level of government but not the other. Itemized deductions for federal and state income tax also are similar, except that state income tax may be deducted in calculating federal taxable income while federal income tax may be deducted in calculating state taxable income. Through tax year 2004, marginal tax rates range from 2% to 11%. Beginning with tax year 2005 marginal rates will range from 1% to 6.9%. Montana also allows a number of credits that may reduce taxpayers' liabilities. Between \$1 million and \$3 million of income tax revenue is allocated to pay for the Department of Revenue's new data processing system. The remainder is allocated 100% to the general fund.

Historical and Projected Revenue

Individual income tax is the single largest source of revenue to the general fund. In FY 2004, individual income tax collections were 43.8% of total general fund revenue. Table 1 shows individual income tax collections for FY 1994 through FY 2004 and projected collections for FY 2005 through FY 2007.

Table 1				
Individual Income Tax Collections				
(\$ millions)				
Fiscal Year	Collections	General Fund	Percent Change	
A 1994	\$345.643	\$345.643	-3.18%	
A 1995	\$371.903	\$371.903	7.60%	
A 1996	\$383.092	\$383.092	3.01%	
A 1997	\$406.276	\$406.276	6.05%	
A 1998	\$444.191	\$444.191	9.33%	
A 1999	\$483.032	\$483.032	8.74%	
A 2000	\$516.262	\$516.262	6.88%	
A 2001	\$556.015	\$556.015	7.70%	
A 2002	\$517.568	\$517.568	-6.91%	
A 2003	\$535.831	\$535.831	3.53%	
A 2004	\$605.582	\$605.348	12.97%	
F 2005	\$616.543	\$615.267	1.64%	
F 2006	\$596.276	\$593.502	-3.54%	
F 2007	\$618.430	\$615.247	3.66%	

Fiscal Year	Revenue
1994	345.643
1995	371.903
1996	383.092
1997	406.276
1998	444.191
1999	483.032
2000	516.262
2001	556.015
2002	517.568
2003	535.831
2004	605.582
2005	616.543
2006	596.276
2007	618.430

Income tax revenue grew fairly steadily from FY 1994 to FY 2001. Revenue grew faster than normal in the second half of the 1990s as the national economy went through a prolonged expansion and the optimism that fueled a rapidly rising stock market led to large increases in capital gains income. Revenue dropped by almost 7% in FY 2002 as the national economy went through a recession and the stock market bubble burst. Revenue grew 3.5% in FY 2003 as the national economy recovered slowly and taxpayers realized the paper losses they had incurred in the stock market. In FY 2004, revenue grew by 13%. Income is projected to continue to grow strongly through FY 2006, but revenue is projected to grow by only 1.6% in FY 2005 and to decrease by 3.6% in FY 2006 as the rate reductions in SB 407 (2003 session) go into effect January 1, 2005. Income growth is projected to slow in FY 2007, but revenue is projected to grow by 3.7%.

Forecast Summary

Income tax collections through FY 2007 are affected by the projected growth of income and changes to tax rates, deductions, and credits enacted in SB 407 (2003 session).

Income Growth

Table 2 shows income reported on tax returns for calendar year (CY) 2003 and CY 2004 and projections for CY 2005 through CY 2007. The table also shows income divided into five categories and the total and annual percentage growth rates.

Table 2										
Forecast Income Growth										
Income Source	----CY 2003----		----CY 2004----		----CY 2005----		----CY 2006----		----CY 2007----	
	\$ billion	% Chg	\$ billion	% Chg	\$ billion	% Chg	\$ billion	% Chg	\$ billion	% Chg
Labor	9.650	4.1%	10.285	6.6%	10.795	5.0%	11.157	3.4%	11.541	3.4%
Ownership	1.753	0.9%	1.862	6.3%	2.008	7.8%	2.094	4.3%	2.230	6.5%
Retirement	1.575	4.7%	1.636	3.8%	1.726	5.5%	1.805	4.6%	1.887	4.6%
Gains/Losses	0.846	26.3%	0.980	15.8%	0.881	-10.2%	0.833	-5.4%	0.838	0.5%
Interest	0.453	-14.4%	0.383	-15.6%	0.417	8.9%	0.526	26.4%	0.539	2.4%
Total	14.277	4.2%	15.146	6.1%	15.826	4.49%	16.415	3.72%	17.034	3.77%

The labor category consists of income reported on tax returns as wages and salaries. The ownership category consists of dividends; net business income; rents, royalties, and partnership income; net farm income; and income reported as other income. The retirement category consists of the taxable portion of Social Security, taxable pensions, and taxable IRA distributions.

Table 3 compares the forecast average annual growth rates through CY 2007 with average annual growth rates from CY 1987 through CY 2003.

Table 3		
Income Growth - Forecast and History		
Income Source	-----Average Annual Growth Rates-----	
	CY 1987-CY 2003	CY 2004-CY 2007
Labor	5.2%	4.6%
Ownership	8.8%	6.2%
Retirement	9.4%	4.6%
Gains/Losses	5.9%	-0.3%
Interest	-1.4%	4.4%
Total	5.5%	4.5%

Since CY 1987, labor income has grown at an average rate of 5.2%. The forecast is for labor income to grow faster than 5.2% in CY 2004 and then slow in CY 2005 through CY 2007. The average growth rate of labor income is projected to be 0.6% lower in CY 2004 through CY 2007 than in CY 1987 through CY 2003.

Ownership income grew at an average rate of 8.8% from CY 1987 through CY 2003. The forecast is for ownership income to grow slower in CY 2004 through CY 2007. The average forecast growth rate is 6.2%.

Retirement income grew at an average rate of 9.4% from CY 1987 through CY 2003. The forecast is for retirement to grow at an average rate of 4.6%. Retirement income is projected to grow faster in CY 2005 than in the other years because of expected movements in the stock market and growth of the national economy.

Gains and losses on the sale of assets grew at an average annual rate of 5.9% from CY 1987 through CY 2003. However, gains and losses have been quite volatile in the recent past. They grew at an average rate of 18.5% from CY 1995 through CY 2000 and then fell at an average rate of 28.4% from CY 2000 through CY 2002. Gains and losses increased by 26.3% in CY 2003. They are forecast to increase by 15.8% in CY 2004, which will put them at 75% of their peak level in CY 2000, but then to decrease in CY 2005 and CY 2006.

Interest income varies significantly with interest rates. It fell in CY 2002 and CY 2003 as interest rates dropped to historic lows. Interest income is forecast to fall again in CY 2004 and then to begin rising in CY 2005 following increases in interest rates beginning in CY 2004.

Total income grew at an average annual rate of 5.5% from CY 1987 to CY 2003. During the same period, income tax collections grew at an average annual rate of 6.7%. With income growing faster than inflation, rate brackets and deductions indexed for inflation, and no changes to rates, income tax collections generally can be expected to grow slightly faster than income. With significant rate changes beginning in CY 2005, collections will grow slower than income for the next several years.

SB 407 – New Rate Table

SB 407 (2003 session) reduced income tax rates, provided for a credit for part of capital gains income, and limited the itemized deduction for federal income taxes. Table 4 shows the rate tables in effect for CY 2004, the last year before the income tax provisions of SB 407 go into effect, and for CY 2005, the first year SB 407 is in effect. The new rate table has fewer rates and lower minimum and maximum rates.

Table 4			
Income Tax Rate Tables Before and After SB 407			
Projected 2004 Rate Table (before SB407)		2005 Rate Table (after SB407)	
Taxable Income	Tax	Taxable Income	Tax
\$2,300 or less	2% of taxable income	\$2,300 or less	1% of taxable income
\$2,301 to \$4,600	3% minus \$23	\$2,301 to \$4,100	2% minus \$23
\$4,601 to \$9,100	4% minus \$69	\$4,101 to \$6,200	3% minus \$64
\$9,101 to \$13,700	5% minus \$160	\$6,201 to \$8,400	4% minus \$126
\$13,701 to \$18,200	6% minus \$297	\$8,401 to \$10,800	5% minus \$210
\$18,201 to \$22,800	7% minus \$479	\$10,301 to \$13,900	6% minus \$318
\$22,801 to \$31,900	8% minus \$707	over \$13,901	6.9% minus \$443
\$31,901 to \$45,500	9% minus \$1,026		
\$45,501 to \$79,700	10% minus \$1,481		
over \$79,700	11% minus \$2,278		

The two rate tables were used to calculate tax liability for taxable incomes ranging from \$0 to \$1 million. In CY 2005, taxpayers with taxable income less than \$16,300 or more than \$24,100 will have lower income tax liability. Taxpayers with taxable income between \$16,300 and \$24,100 will have their tax liability increased, but by less than \$20. The change in rates will reduce total tax liability.

SB 407 – Limit on Deduction for Federal Income Tax

SB 407 limits the itemized deduction for federal taxes to \$10,000 for married couples filing jointly and \$5,000 for other filers. This has no effect on taxpayers who take the standard deduction or taxpayers who itemize but pay less than \$5,000 in federal income tax (\$10,000 if filing jointly). For taxpayers who pay more federal income tax, the limited deduction for federal income tax increases their taxable income and, therefore, their tax.

Taxpayers who claim an itemized deduction for federal taxes paid during a year reduce their state income tax liability. If it turns out that they over paid federal taxes that year and receive a refund the next year, that refund must be reported as income for state income tax. This results in the taxpayer's state taxable income being reduced by the net amount paid to the federal government each year, i.e., taxes paid

less refunds. This is referred to as the tax benefit rule – a federal income tax refund must be counted as income if the taxpayer received the benefit of deducting it the previous year.

Beginning in CY 2005, any federal income tax paid over the \$5,000 cap (\$10,000 for joint filers) does not reduce state income tax so there is no state tax benefit from federal taxes paid over the cap. If the taxpayer receives a refund the next year, it will be counted as income only to the extent that it reduces the net amount paid (federal tax paid minus the refund) below the cap. For example, a married taxpayer filing jointly who paid \$11,000 in federal tax in CY 2005 and received a refund of \$100 in CY 2006 would not have to report it as income. A married taxpayer filing jointly who paid \$11,000 in federal tax and received a refund of \$1,100 would have to report \$100 as income.

The tax benefit rule reduces taxable income and tax liability for some taxpayers with federal income tax over the cap, partially offsetting the additional tax paid because of the cap.

The net effect of the cap on federal deductibility is to increase tax liability of higher income taxpayers, but by less than the new rate table reduces it.

Recent federal legislation has raised the income level at which alternative minimum tax applies, but only through CY 2005. Under current law, the number of taxpayers paying federal alternative minimum tax will increase significantly in CY 2006, and these taxpayers will pay more federal income tax. Without SB 407, this would reduce their state income tax liability. However, many of these taxpayers are near or over the cap on federal deductibility, and the increase in federal income tax payments will have a very small effect on state tax liability.

Congress is very likely to permanently increase the alternative minimum tax threshold before CY 2006. Because of the cap on federal deductibility, this change will have a minimal effect on state income tax collections.

SB 407 – Capital Gains Credit

In CY 2005 and CY 2006, taxpayers will be allowed to claim a tax credit equal to 1% of their capital gains income. Beginning in CY 2007, the credit will be 2% of capital gains income. This is equivalent to taxing capital gains at a lower rate than other income. This reduces total tax liability.

Forecast – Effects of Income Growth and SB 407

Table 5 shows how forecast income growth and SB 407 affect income tax collections. The second and third columns show collections and their annual

percent growth with forecast income growth and the pre-SB 407 tax law. The fourth and fifth columns shows collections and their annual percent growth with forecast income growth and SB 407. The two right hand columns show the effects of SB 407 on collections and their growth rate.

Table 5 Revenue Impacts of Income Growth and SB 407 (\$ millions)						
Fiscal Year	Old Law with Forecast Income Growth		SB 407 with Forecast Income Growth		SB 407 Impact	
	Collections	% Change	Collections	% Change	Collections	Growth Rate
F 2005	630.365	4.09%	608.524	0.49%	-21.841	-3.61%
F 2006	640.122	1.55%	604.295	-0.69%	-35.826	-2.24%
F 2007	652.744	1.97%	618.430	2.34%	-34.314	0.37%

Income is forecast to grow slightly slower than the average rate of the last fifteen years. By itself, this would produce slower growth in income tax collections. In FY 2005 and FY 2006, SB 407 will reduce collections by about as much as income growth would have increased them. The result is very little growth in collections in FY 2005 and reduced collections in FY 2006. Collections are forecast to resume growing in FY 2007, and collections growth from FY 2007 on will be driven by income growth.

Forecast Methodology and Projection Calculation

The process of estimating income tax revenue centers around a computer program that calculates tax liability for individual income tax returns. The program reads all of the information from each full year resident return in the latest year's income tax returns database. For each return, it calculates the current year's tax liability. It then applies an annual growth rate to each of the income and deduction line items on the return and calculates the next year's tax liability. It repeats this process, growing income and deductions and calculating tax liability, for each year of the forecast.

Before the program is run, growth rates for income and deduction line items must be forecast and future tax parameters, such as rate brackets and caps on deductions must be calculated based on forecasts of inflation and any changes in state or federal law.

After the program is run, the growth in calendar year tax liability for full year filers that it produces is used to estimate growth in fiscal year revenue.

The estimation process can be divided into eight steps:

1. Forecast growth rates for individual income and deduction line items and number of taxpayers.
2. Divide income and deduction growth by growth in taxpayers to give per capita growth.
3. Incorporate changes in state and federal law and forecast inflation into the program for calculating future years' tax liability.
4. Use the program to calculate tax liability in CY 2003 through CY 2007 for full year residents who filed a return for CY 2002 assuming that their income and deductions line items grow as forecast. Adjust the future tax liability of CY 2002 full year filers for the percentage of taxes paid by non-residents and part-year residents and for population growth to estimate total liability for each calendar year.
5. Estimate credits that will be claimed each year and subtract this amount from total liability to give the calendar year tax associated with returns.
6. Allocate calendar year tax to fiscal years and calculate annual growth rates of fiscal year tax liability.
7. Apply the fiscal year growth rates to the last full fiscal year's revenue with audit revenue removed to give fiscal year collections without audit revenue.
8. Add projected audit revenue and any other adjustments to give estimates of fiscal year revenue.

Forecast Growth Rates for Income and Deduction Line Items

Taxpayers report income on up to eleven lines on the tax return. In Table 2, these were combined into five categories, but each line is forecast separately. Table 6 shows the eleven income line items and their categories, the amount of income reported for CY 2003 by full year residents, the percentage of total income in that category in CY 2003, and the percentage of income reported in that category over the last ten years.

Table 6			
Calendar Year Income Reported by Full Year Residents			
Type of Income	CY 2003 Income (\$ millions)	% of CY 2003 Income	% of CY 1993 - CY 2003 Income
Labor Income			
Wages, salaries, tips, etc.	\$9,649.687	67.59%	65.30%
Ownership Income			
Rents, royalties, partnerships, etc.	\$1,019.724	7.14%	6.48%
Net business income	\$629.701	4.41%	4.91%
Dividend income	\$297.423	2.08%	2.50%
Net farm income	-\$146.211	-1.02%	-0.81%
Other income	-\$47.936	-0.34%	-0.21%
Retirement			
Taxable portion of Soc. Sec.	\$267.287	1.87%	1.64%
Taxable Pensions, IRAs	\$1,307.739	9.16%	8.39%
Gains and Losses			
Capital gain or (loss)	\$790.913	5.54%	6.67%
Supplemental gains or (losses)	\$55.547	0.39%	0.37%
Interest			
Interest income	\$453.025	3.17%	4.76%
TOTAL INCOME	\$14,276.899	100.00%	100.00%

The largest income type is wages, salaries, tips, and other labor income. It accounts for about two-thirds of income.

Ownership income is reported on five tax return lines.

Rents, royalties, and partnership income is income from ownership of tangible or intangible property, from a partnership in a business, or from passive participation in a business. It averages about 6.5% of income.

Net business income is income that individuals receive from their direct ownership of a business. It averages about 5% of income. Dividends are income that individuals receive from owning shares of an incorporated business. Dividends average about 2.5% of income.

Net farm income is the net of income and losses from unincorporated agricultural operations and is negative most years.

Other income is income that does not fit on one of the other lines. Total other income generally is negative but small relative to total income.

Retirement income has grown faster than other types of income and is expected to continue to do so. Retirement income is reported on two lines.

The taxable portion of Social Security averaged 1.6% of income from CY 1993 through CY 2003.

Taxable retirement income from pensions, IRA distributions, and other sources except Social Security averaged 8.4% of income.

Gains and losses from the sale of assets are reported on two lines. Most are reported as capital gains. A small amount of gains or losses on the sale of business assets are reported as supplemental gains. Together, capital gains and supplemental gains averaged a little more than 7% of revenue over the last ten years, but this period includes the unusually high capital gains of the late 1990s.

Interest averages about 5% of reported income, but varies from year to year.

Wages and Salaries

Wage and salary income is estimated in two steps. First, Global Insight's forecasts of Montana employment and average annual wages for 16 sectors of the state economy are used to construct a forecast of total wage and salary income. Second, total wage and salary income is adjusted to estimate wages and salaries reported on full year residents' income tax returns.

Table 7 shows the forecasts of employment growth. The first column lists the 16 sectors of the state economy, in decreasing order of employment. The second column shows the percent of state employment in each sector in CY 2003. The third column shows the average growth rate of employment in each sector from CY 1991 through CY 2003. The next four columns show the forecast growth rates for CY 2004 through CY 2007. The final column shows the average forecast growth rates for CY 2004 through CY 2007.

Table 7							
Employment Growth - Calendar Year							
Industry	2003 % of Employ- ment	Growth Rate					Average 2004 - 2007
		Average 1991- 2003	2004	2005	2006	2007	
State & Local Gov't (inc. Schools)	16.00%	1.68%	0.67%	0.96%	0.50%	0.40%	0.63%
Retail Trade	11.94%	1.98%	1.24%	1.09%	1.34%	1.31%	1.24%
Educational and Health Services	11.87%	3.21%	1.36%	2.52%	2.13%	1.39%	1.85%
Leisure and Hospitality	11.62%	2.99%	2.20%	3.09%	2.30%	2.34%	2.48%
Agriculture, Forestry, and Fishing	9.06%	0.82%	0.76%	1.99%	1.26%	1.21%	1.30%
Professional & Business Services	7.30%	5.97%	2.61%	4.47%	3.04%	3.48%	3.40%
Construction	5.14%	5.87%	4.59%	3.47%	1.20%	1.11%	2.58%
Financial Activities	4.51%	2.95%	3.36%	2.04%	0.54%	0.71%	1.66%
Manufacturing	4.21%	-0.12%	1.84%	2.93%	1.02%	0.95%	1.68%
Other Services	3.58%	2.78%	1.22%	-0.07%	0.15%	0.89%	0.55%
Transport, Warehousing, Utilities	3.43%	-0.33%	1.16%	0.75%	0.27%	0.30%	0.62%
Wholesale Trade	3.43%	1.05%	0.46%	1.10%	0.92%	0.61%	0.77%
Federal Government	3.09%	0.42%	1.30%	0.02%	-0.17%	0.07%	0.30%
Military	1.80%	-2.22%	-3.38%	-1.70%	-1.42%	-0.68%	-1.80%
Information	1.69%	1.06%	1.59%	2.26%	-0.19%	1.01%	1.16%
Natural Resources and Mining	1.34%	-1.58%	11.55%	6.81%	1.37%	0.04%	4.84%
Total	100.00%	2.06%	1.66%	2.02%	1.27%	1.24%	1.55%

Overall, employment is forecast to grow at an average rate of 1.55%. This is about half a percentage point lower than the 2.06% average rate of growth in 1991 through 2003. The fastest growing industries are projected to be natural resources and mining, professional and business services, construction, and leisure and hospitality. The only industry projected to lose jobs is the military.

From CY 1991 to CY 2002, Montana's population grew at an average rate of 1.07%. Employment grew faster than the population as the fraction of the population doing paid work increased and the fraction of the population holding more than one job increased. These trends are expected to continue for the near future. Employment growth is forecast to be higher or lower than the average each year in response to differences in national growth.

Table 8 shows the forecasts of growth in average wages. It has the same structure as Table 7 except that industries are sorted by decreasing average wage, which is shown in the second column. Also, Global Insight forecasts construction and mining employment separately but combines them when forecasting average wages.

Table 8							
Growth of Average Wages - Calendar Year							
Industry	2003 Average Wage	Growth Rate					Average 2004 - 2007
		Average 1991- 2003	2004	2005	2006	2007	
Federal Government	\$45,670	3.65%	1.99%	2.52%	2.60%	2.74%	2.46%
Transport, Warehousing, Utilities	\$39,545	3.08%	3.38%	4.08%	3.56%	3.56%	3.64%
Construction and Mining	\$35,594	2.09%	3.88%	4.62%	2.92%	3.10%	3.63%
Manufacturing	\$35,329	3.35%	1.29%	2.39%	2.99%	3.21%	2.47%
Wholesale Trade	\$34,901	2.89%	5.50%	3.29%	3.22%	3.26%	3.81%
Financial Activities	\$34,389	4.15%	5.89%	4.16%	3.69%	4.11%	4.46%
Information	\$33,859	3.20%	6.15%	3.87%	3.94%	3.57%	4.38%
Professional & Business Services	\$29,707	4.24%	3.55%	3.60%	3.47%	3.40%	3.50%
Educational and Health Services	\$29,101	3.90%	4.16%	3.64%	3.68%	3.67%	3.78%
Military	\$26,842	5.10%	7.94%	2.08%	2.11%	2.12%	3.53%
State & Local Gov't (inc. Schools)	\$26,628	3.70%	7.07%	1.97%	2.48%	2.65%	3.52%
Other Services	\$23,689	3.44%	3.70%	2.04%	4.08%	4.04%	3.46%
Retail Trade	\$20,718	3.05%	2.38%	2.42%	2.81%	2.74%	2.59%
Leisure and Hospitality	\$12,442	3.37%	1.06%	3.00%	3.69%	3.57%	2.83%
Agriculture, Forestry, and Fishing	\$5,779	3.05%	3.44%	2.29%	2.37%	2.72%	2.70%
Total	\$25,536	3.31%	4.28%	3.08%	3.03%	3.10%	3.37%

Average annual wages are forecast to grow 0.08% faster in CY 2004 through CY 2007 than they did in CY 1991 through CY 2002. Average wages are forecast to grow fastest in financial activities, information, and the wholesale trade. Average wages are forecast to grow the slowest in the federal government, manufacturing, and retail trade.

Employment in each sector is multiplied by the average wage in each sector to give wage and salary income for each sector. Wage and salary income for the sectors is summed and then the total is adjusted for the difference between wages and salaries reported for income tax and wages and salaries reported for unemployment insurance. From CY 1994 through CY 2003, wages and salaries reported for unemployment insurance grew at an average annual rate of 5.15%. Wages and salaries reported for income tax grew at an average annual rate of 4.94% but varied more from year to year. For each percentage point that growth of wages reported for unemployment insurance exceeds the average of 5.15%, the growth rate of income tax wages exceeds the average of 4.94% by 1.93%.

Table 9 shows total wage and salary income growth in CY 2003 through CY 2007. It also shows wage and salary growth separated into three components: employment growth, inflation, and growth in inflation-adjusted average real wages and salaries.¹

Table 9				
Wage and Salary Income Growth				
Calendar Year	Growth Rate			
	Employment	Real Wage and Salary Income per Employee	Inflation	Wages and Salaries
2004	1.66%	2.21%	2.58%	6.59%
2005	2.02%	1.04%	1.82%	4.95%
2006	1.27%	0.63%	1.42%	3.36%
2007	1.24%	0.46%	1.70%	3.44%
Average 2004 - 2007	1.55%	1.34%	1.88%	4.84%
Average 1991 - 2003	2.06%	0.54%	2.56%	5.25%

Employment grew at an average annual rate of 2.06% from CY 1991 through CY 2003. Employment growth is forecast to be slower in CY 2004 through CY 2007, with an average annual growth rate of 1.55%.

Real inflation-adjusted wage and salary income per employee grew only 0.54% per year from CY 1991 through CY 2003. In CY 2004 through CY 2007 it is forecast to grow at an average annual rate of 1.34%. This is slightly less than Global Insight's forecast of national growth of real wage and salary income per employee, 1.37%.

The average inflation rate was 2.56% from CY 1991 through CY 2003. Global insight forecasts that inflation will remain low through CY 2007, with average inflation of 1.88%.

Faster growth in real wage and salary income per employee is expected to be more than offset by slower employment growth and lower inflation. Total wages and salaries are forecast to grow at an average annual rate of 4.84%, about 0.4% lower than the average growth from CY 1991 through CY 2003.

¹ The growth rate of total wages and salaries equals $(1 + \text{real wage and salary per employee growth rate}) \times (1 + \text{inflation rate}) \times (1 + \text{employment growth rate}) - 1$.

Ownership Income

Table 10 shows dividends; net business income; rents, royalties and partnership income; net farm income; and other income reported on full year residents' income tax returns for CY 1995 through CY 2003 and forecasts for CY 2004 through CY 2007.

CY	Dividends		Net Business Income		Rents, Royalties and Partnership		Net Farm Income		Other Income	
	\$ millions	% chg.	\$ millions	% chg.	\$ millions	% chg.	\$ millions	% chg.	\$ millions	% chg.
A 1995	278.478		551.270		629.647		-95.456		0.918	
A 1996	291.415	4.6%	544.993	-1.1%	645.596	2.5%	-105.452	10.5%	-22.219	-2521.7%
A 1997	323.151	10.9%	554.537	1.8%	664.947	3.0%	-98.433	-6.7%	-36.415	63.9%
A 1998	312.283	-3.4%	584.178	5.3%	709.340	6.7%	-135.309	37.5%	-37.887	4.0%
A 1999	340.081	8.9%	599.189	2.6%	813.250	14.6%	-75.241	-44.4%	-56.774	49.9%
A 2000	374.794	10.2%	606.597	1.2%	894.050	9.9%	-77.473	-3.0%	-32.694	42.4%
A 2001	302.464	-19.3%	617.943	1.9%	917.394	2.6%	-112.633	-45.4%	-22.436	31.4%
A 2002	264.875	-12.4%	620.572	0.4%	1014.593	10.6%	-157.525	-39.9%	-5.377	76.0%
A 2003	297.423	12.3%	629.701	1.5%	1019.724	0.5%	-146.211	7.2%	-47.936	-791.5%
F 2004	314.417	5.7%	646.203	2.6%	1099.276	7.8%	-149.576	-2.3%	-47.936	0.0%
F 2005	318.661	1.3%	664.777	2.9%	1203.911	9.5%	-131.550	12.1%	-47.936	0.0%
F 2006	337.756	6.0%	682.808	2.7%	1275.066	5.9%	-154.045	-17.1%	-47.936	0.0%
F 2007	357.919	6.0%	701.198	2.7%	1381.619	8.4%	-163.224	-6.0%	-47.936	0.0%

* Net Farm Income and Other Income are negative. For display purposes, a change to a smaller negative value is shown as a positive percentage change and a change to a larger negative value is shown as a negative percentage change.

Montana dividends and net business income are highly correlated with their national equivalents. Growth of Montana dividend income is forecast to be a constant proportion to growth of national dividend income. Dividends fell by 19% in CY 2001 and 12% in CY 2002 because of the national recession. In CY 2003, dividend income recovered almost to its CY 2001 level. It is forecast to continue growing from this reduced base.

Net business income is less volatile than dividends. The growth rate of Montana net business income is forecast based on the previous year's growth rate and the growth rate of national proprietors' income. Growth of net business income in Montana slowed in CY 2000 through CY 2002 as the national economy went into a recession. It grew slightly faster in CY 2003 and is projected to grow by between 2.6% and 2.9% in CY 2004 through CY 2007.

The growth rate of rents, royalties and partnership income is forecast based on the growth rate of national rental income and recent differences between actual and predicted growth rates. It is forecast to grow fairly rapidly through CY 2007. Mineral royalties are generally reported in this category, and high oil and natural gas prices will contribute to this growth.

Net farm income has been negative in recent years and is projected to stay negative. Net farm income is forecast using forecasts of beef and wheat prices from the U.S. Department of Agriculture, a time trend, and deviations of recent income from the trend.

The other income line is a catchall for income that does not fit on the other lines. Other income is small and is forecast to be constant.

Retirement Income

Statistical tests were performed to find national data series forecast by Global Insight that are correlated with taxable pensions and IRA distributions and the taxable portion of Social Security reported by full year residents. Taxable pensions and IRA distributions were found to be explained best by last years' S&P 500 stock price index and last year's U.S. gross domestic product and recent differences between actual and predicted pension income. Taxable Social Security is forecast based on Montana population age 65 and older and inflation.

Table 11 shows actual taxable pension and IRA distributions and taxable Social Security for CY 2000 through CY 2003 and forecasts for CY 2004 through CY 2007.

Table 11 Retirement Income				
Calendar Year	Pensions and IRAs		Social Security	
	\$ millions	% change	\$ millions	% change
A 2000	1206.261	8.9%	255.297	16.1%
A 2001	1233.690	2.3%	257.153	0.7%
A 2002	1250.389	1.4%	254.249	-1.1%
A 2003	1307.739	4.6%	267.287	5.1%
F 2004	1353.324	3.5%	282.185	5.6%
F 2005	1432.794	5.9%	293.185	3.9%
F 2006	1500.810	4.7%	303.981	3.7%
F 2007	1570.374	4.6%	316.624	4.2%

Capital Gains and Supplemental Gains

Capital gains and supplemental gains are gains or losses from the sale of assets. Gains or losses on the sale of property used in the owner's trade or business, mineral rights, and business inventories generally are reported as supplemental gains. Gains or losses on the sale of other assets generally are reported as capital gains.

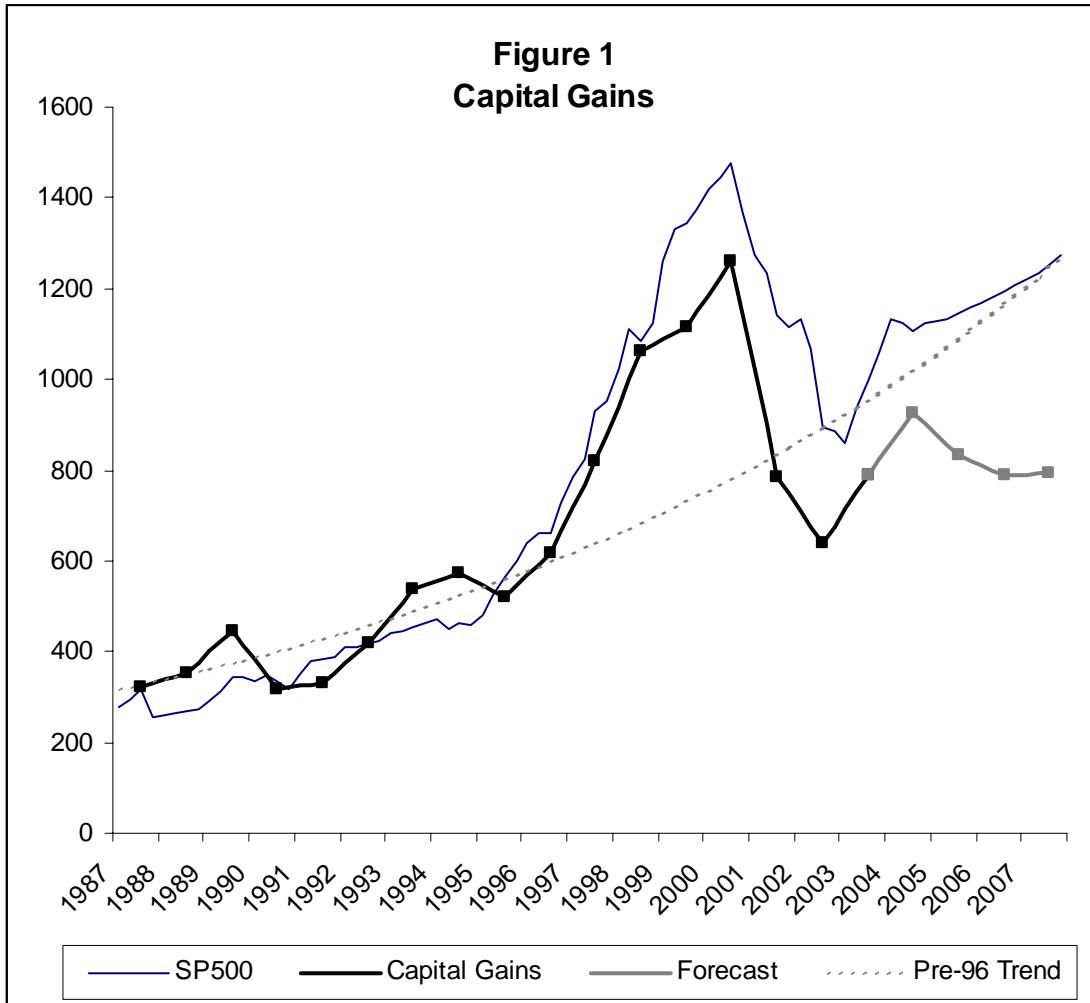
Table 12 shows capital gains and supplemental gains, in millions of dollars and as a percent of income, from CY 1987 through CY 2003. Both show considerable variability with year-to-year changes (up or down) averaging 20% over this period.

Table 12						
Capital Gains and Supplemental Gains CY 1987 - CY 2003						
Calendar Year	Capital Gains			Supplemental Gains		
	\$ millions	% chg.	% of Income	\$ millions	% chg.	% of Income
A 1987	322.597		5.33%	17.376		0.29%
A 1988	353.657	9.6%	5.31%	31.293	80.1%	0.47%
A 1989	446.432	26.2%	6.27%	31.831	1.7%	0.45%
A 1990	318.211	-28.7%	4.23%	34.467	8.3%	0.46%
A 1991	331.219	4.1%	4.16%	32.339	-6.2%	0.41%
A 1992	416.698	25.8%	4.83%	32.040	-0.9%	0.37%
A 1993	536.271	28.7%	5.91%	44.765	39.7%	0.49%
A 1994	573.637	7.0%	6.01%	40.441	-9.7%	0.42%
A 1995	521.183	-9.1%	5.24%	36.930	-8.7%	0.37%
A 1996	616.453	18.3%	5.84%	38.126	3.2%	0.36%
A 1997	818.544	32.8%	7.30%	51.468	35.0%	0.46%
A 1998	1060.174	29.5%	8.75%	47.856	-7.0%	0.39%
A 1999	1115.780	5.2%	8.76%	44.391	-7.2%	0.35%
A 2000	1259.720	12.9%	9.16%	46.175	4.0%	0.34%
A 2001	785.759	-37.6%	5.74%	42.906	-7.1%	0.31%
A 2002	637.444	-18.9%	4.65%	32.565	-24.1%	0.24%
A 2003	790.913	24.1%	5.54%	55.547	70.6%	0.39%

Capital gains followed a general upward trend from CY 1990 through CY 2000. During this period, capital gains increased almost four-fold and grew from 4.2% of income to 9.2% of income. This coincided with a prolonged period of economic expansion that culminated in the stock market bubble of the late 1990s. The expansion ended and the stock market crashed in CY 2000, and capital gains fell by almost half from CY 2000 to CY 2002.

Capital gains or losses result when the price of an asset rises or falls between the time it is bought and the time it is sold. Statistical models were estimated relating capital gains to changes in stock prices. Only a portion of capital gains are from sales of stocks, but stocks are the only assets for which reliable price data are available, and most asset values are affected similarly by general economic conditions and investor optimism or pessimism. Thus, stock prices serve as a general indicator of the value of assets. The model that fit the data best predicts capital gains based on an average of the differences between the current value of the S&P 500 stock index and its value in the last eleven years.

Figure 1 shows actual capital gains in CY 1987 through CY 2003, the actual average quarterly S&P 500 in CY 1987 through CY 2003, Global Insight's forecast of the quarterly average S&P 500 through CY 2007, and the annual forecast of capital gains for CY 2003 through CY 2007. It also shows a trend line based on capital gains in CY 1987 through CY 1995, the years immediately before the stock market bubble.



Through CY 1995, stock prices rose steadily. Capital gains varied from year to year, but had about the same average growth as stock prices. From CY 1996 through CY 1999, stock prices rose rapidly. Capital gains rose rapidly in CY 1997 and CY 1998 as many assets were being sold for significantly more than was paid for them. Capital gains growth slowed in CY 1999, before the stock market peaked. Although asset prices continued to rise, an increasing percentage of assets had been purchased after prices had started rising rapidly. Stock prices peaked in CY 2000. They fell rapidly in CY 2001 and CY 2002 and continued to fall, but not as rapidly, in CY 2003. Capital gains fell even more rapidly than stock prices in CY 2001. Not only were selling prices lower, some of the assets being sold had been bought

during the peak years and were being sold for a loss. Capital gains fell more slowly than stock prices in CY 2002. They recovered somewhat in CY 2003 as the stock market recovered and investors began selling some of the assets they bought during the trough in CY 2001 and CY 2002. Stock prices continued to rise through the first half of CY 2004, but fell slightly in the third quarter. Stock prices are projected to rise slowly through CY 2007.

Capital gains are projected to be higher in CY 2004 than in CY 2003, reflecting the 25% increase in the S&P 500 from the first quarter of CY 2003 to the second quarter of CY 2004. They are projected to be close to the CY 2003 level in CY 2005 through CY 2007 as stock prices rise slowly. Capital gains are projected to remain well below the pre-stock-bubble trend through CY 2007 even though asset prices are projected to be rising and close to the trend. A significant percentage of assets sold during the next few years will have been bought at inflated prices between CY 1996 and CY 2001 and will be sold for a loss or minimal gain.

Supplemental gains follow the same cycles as capital gains but follow them differently. Cycles in the capital gains growth rate have long, smooth peaks and short, sharp troughs. Cycles in the supplemental gains growth rate have short sharp peaks and long smooth troughs. The growth rate of supplemental gains is forecast using the forecast growth rate for capital gains and an indicator variable for peaks in the capital gains cycle. Table 13 shows the forecasts of capital gains and supplemental gains for CY 2004 through CY 2007.

Table 13				
Capital and Supplemental Gains Forecasts				
Calendar Year	Capital Gains		Supplemental Gains	
	\$ millions	% chg.	\$ millions	% chg.
F 2004	926.935	17.2%	53.420	-3.8%
F 2005	831.049	-10.3%	49.492	-7.4%
F 2006	786.957	-5.3%	46.203	-6.6%
F 2007	794.154	0.9%	43.462	-5.9%

Interest Income

Interest earnings depend on taxpayers' savings and interest rates. Statistical models were estimated to find relationships between interest income, various short- and long-term interest rates, and indicators of economic activity. The model that fits the data best predicts interest earnings using a time trend to capture the growth in taxpayers' savings, the current and last year's average rates on three-month certificates of deposit, and differences between recent interest income and predicted values.

Table 14 shows actual interest income and interest rates on three-month certificates of deposit for CY 1995 through CY 2003 and forecasts through CY 2007. Interest income decreased by 20% in CY 2002 and 14% in CY 2003 as interest rates fell. It is projected to decline in CY 2004 because interest rates continued to fall in CY 2003 and then stayed low. Interest income is forecast to increase in CY 2005 through CY 2007, but still to be lower in CY 2007 than in CY 1995 through CY 2002.

Table 14			
Interest Income			
Calendar Year	3 Month CD Rate	Interest Income	
		\$ millions	% chg.
A 1995	5.92%	550.441	
A 1996	5.39%	589.569	7.1%
A 1997	5.61%	595.108	0.9%
A 1998	5.47%	621.815	4.5%
A 1999	5.32%	602.599	-3.1%
A 2000	6.46%	652.744	8.3%
A 2001	3.73%	662.617	1.5%
A 2002	1.73%	528.959	-20.2%
A 2003	1.15%	453.025	-14.4%
F 2004	1.52%	382.552	-15.6%
F 2005	2.87%	416.515	8.9%
F 2006	3.56%	526.288	26.4%
F 2007	3.67%	538.930	2.4%

Adjustments to Income

A taxpayer's federal adjusted gross income is the sum of the eleven income line items shown above minus adjustments to income, which include un-reimbursed expenses, IRA contributions, and alimony paid. Montana adjusted gross income is federal adjusted gross income plus income that the state taxes but the federal government does not tax, minus income that the federal government taxes but the state does not. Table 15 shows actual growth rates of adjustments to income and income that Montana taxes but the federal government exempts in CY 2001 through CY 2003 and forecasts for CY 2004 through CY 2007.

Table 15				
Annual Growth Rates of Adjustments to Income and Income Montana Taxes but Federal Government Exempts				
Year	Adjustments to Income	Out-of-State		
		Municipal Bond Interest	Federal Income Tax Refunds	Other Additions
2001	1.28%	4.78%	10.24%	0.73%
2002	23.21%	-2.97%	21.34%	2.63%
2003	15.69%	4.01%	3.88%	18.14%
2004	6.68%	11.16%	-2.13%	-15.88%
2005	6.68%	5.62%	10.87%	0.00%
2006	6.67%	-2.91%	5.68%	0.00%
2007	6.67%	4.55%	5.37%	0.00%

Adjustments to income are forecast using a time trend.

Income taxable in Montana that is not taxed by the federal government is reported in three categories: interest on municipal bonds from other states, federal income tax refunds, and all other.

Interest on municipal bonds is forecast using the current and last year's average interest rate on municipal bonds, a time trend to account for growth in bond holdings over time, and differences between recent income and predicted values.

Federal income tax refunds are forecast using a time trend and recent deviations from the trend. Beginning in CY 2005, the simulation program reduces the amount of each federal refund that is included in income by the amount that federal taxes paid exceed the cap on deductibility of federal taxes in SB 407.

When taxpayers report income in the all other category, it usually is because they have elected to have income taxed differently at the state and federal level. Other additions to income varies from year to year but shows no trend. It was significantly higher in CY 2003 than in previous years. It is projected to return to the average level in CY 1987 through CY 2003 and then remain at that level.

Table 16 shows actual growth rates of income that Montana exempts but the federal government taxes in CY 2001 through CY 2003 and forecasts for CY 2004 through CY 2007.

Table 16 Annual Growth Rates of Income Montana Exempts but Federal Government Taxes						
Year	Savings Bond Interest	Unemploy- ment Compen- sation	Medical Savings Accounts	Family Education Accounts	First Time Homebuyers Accounts	Other Reductions
A 2001	-12.81%	17.40%	21.63%	61.24%	23.47%	6.46%
A 2002	-30.61%	31.53%	20.56%	60.42%	1.76%	5.44%
A 2003	-20.93%	9.50%	14.70%	20.15%	14.94%	6.83%
F 2004	-8.29%	-29.99%	13.65%	16.58%	13.05%	5.38%
F 2005	9.55%	0.00%	12.01%	14.22%	13.05%	5.38%
F 2006	24.55%	0.00%	10.73%	12.45%	13.05%	5.38%
F 2007	3.70%	0.00%	9.69%	11.07%	13.05%	5.38%

Income that the federal government taxes but Montana does not is reported in nine categories, but only six are shown in Table 16. The interest exclusion for the elderly and exempt retirement are calculated for each return in the simulation program, so that no overall growth rate is forecast for them. The farm risk management account

exemption has only been in effect for two years. With no history to go on, it is forecast to be constant at the CY 2003 level.

Interest on savings bonds is forecast as a growing percentage of interest income.

Unemployment compensation varies over the course of business cycles but does not show a trend. Unemployment compensation was higher than normal in CY 2002 and CY 2003 because of the recession and jobless recovery. Employment is forecast to continue to grow steadily, and unemployment compensation should return to normal levels. CY 2001 is the latest year with normal unemployment compensation. The forecast is for unemployment compensation to be constant at the CY 2001 level, which is 29.99% lower than the CY 2003 level.

Medical savings account and family education account contributions and interest are forecast to increase each year by the average of the last six years' increases.

First time homebuyers account contributions and interest has grown rapidly since this exemption was introduced. It is forecast to grow at the average growth rate from CY 1999 through CY 2003.

Other reductions are forecast to grow at the average of past annual growth rates.

Deductions

Montana taxable income is Montana adjusted gross income less deductions. Many taxpayers claim the standard deduction. Taxpayers who itemize deductions may claim deductions in fourteen categories.

1. Medical insurance premium deductions are forecast to grow at the average rate of growth in recent years.
2. Medical expense deductions are forecast to grow at the average rate of growth in recent years.
3. Deductions for long-term care insurance are forecast to grow by the average amount of growth in recent years.
4. Deductions for federal income tax payments are calculated in the simulation program. This calculation uses growth rates for back year taxes and payments made with returns. Beginning in CY 2005, the calculation incorporates the limits on this deduction in SB 407. Back year taxes are forecast to be constant at the average in CY 1994 through CY 2003 and payments with returns are forecast with a time trend.
5. Deductions for real estate taxes are based on the property tax forecast.
6. Deductions for vehicle taxes are based on the vehicle fees forecast.

7. Mortgage interest deductions are forecast using the average interest rate on 30-year mortgages, the average price of existing houses, and recent differences between actual and predicted deductions.
8. Deductions for investment interest are forecast using a trend, the interest rate on three-month certificates of deposit, and recent differences between actual and predicted deductions.
9. Deductions for charitable contributions are forecast using a trend and recent differences between actual and predicted deductions.
10. Deductions for child and dependent care expenses are forecast using a trend and recent differences between actual and predicted growth rates.
11. Deductions for casualty and theft losses are forecast to grow by the average amount of growth in recent years.
12. Deductions in the first miscellaneous category are forecast to grow by the average amount of growth in recent years.
13. Deductions in the second miscellaneous deduction category are forecast using a trend and recent differences between actual deductions and the trend.
14. Deductions for gambling losses are forecast to be constant at the CY 2003 level.

Table 17 shows actual growth rates of itemized deduction line items for CY 2001 through CY 2003 and forecasts for CY 2004 through CY 2007.

Table 17					
Annual Growth Rates of Itemized Deductions					
<u>CY</u>	<u>Medical Insurance Premiums</u>	<u>Medical and Dental Expenses</u>	<u>Long Term Care Insurance</u>	<u>Federal Income Tax Paid with Return</u>	<u>Back Year Federal Taxes</u>
A 2001	8.97%	9.95%	4.14%	2.51%	61.28%
A 2002	9.89%	9.71%	12.98%	-21.55%	-31.92%
A 2003	-1.99%	6.12%	8.86%	-5.09%	-7.46%
F 2004	5.17%	8.24%	7.74%	2.91%	-4.76%
F 2005	5.17%	8.24%	7.18%	2.82%	0.00%
F 2006	5.17%	8.24%	6.70%	2.75%	0.00%
F 2007	5.17%	8.24%	6.28%	2.67%	0.00%

<u>Year</u>	<u>Real Estate Taxes</u>	<u>Vehicle Taxes</u>	<u>Mortgage Interest</u>	<u>Investment Interest</u>	<u>Contributions</u>
A 2001	3.70%	-18.12%	7.03%	-9.45%	3.57%
A 2002	10.66%	11.63%	4.15%	-22.57%	13.05%
A 2003	5.99%	3.00%	-1.05%	-12.23%	-2.26%
F 2004	4.17%	3.00%	14.79%	-2.80%	7.50%
F 2005	4.29%	3.00%	11.37%	16.68%	13.18%
F 2006	4.37%	3.00%	10.97%	-5.19%	13.75%
F 2007	4.48%	3.00%	4.56%	8.12%	9.28%

<u>CY</u>	<u>Child and Dependent Care Expenses</u>	<u>Casualty and Theft Losses</u>	<u>Miscellaneous I</u>	<u>Miscellaneous II</u>	<u>Gambling Losses</u>
A 2001	-7.59%	-56.20%	9.07%	-0.26%	-14.98%
A 2002	1.57%	41.33%	3.81%	13.45%	0.14%
A 2003	2.18%	-8.03%	0.45%	67.50%	-3.55%
F 2004	2.84%	3.79%	3.83%	-28.97%	0.00%
F 2005	-5.67%	3.65%	3.69%	10.70%	0.00%
F 2006	-2.86%	3.52%	3.56%	7.68%	0.00%
F 2007	-3.08%	3.40%	3.44%	6.95%	0.00%

Population Growth

The simulation program estimates future years' tax liability for taxpayers who filed returns for the last tax year. This must be adjusted for growth in the number of taxpayers. Statistical analysis shows that growth in the number of tax returns filed by full year residents is highly correlated with employment growth. When employment increases by 1,000, the number of full year resident tax returns

increases by 892. Table 18 shows employment and the number of full year resident returns for CY 1990 through CY 2003 and projections for CY 2004 through CY 2007. The employment projections were developed as part of the wage and salary income estimates explained above.

Table 18				
Employment and Full Year Resident Returns				
<u>CY Year</u>	<u>Employment</u>	<u>% chg.</u>	<u>Returns</u>	<u>% chg.</u>
A 1990	297,242		391,191	
A 1991	303,608	2.14%	403,343	3.11%
A 1992	316,558	4.27%	413,634	2.55%
A 1993	325,608	2.86%	419,274	1.36%
A 1994	340,142	4.46%	431,778	2.98%
A 1995	350,733	3.11%	442,031	2.37%
A 1996	360,308	2.73%	449,231	1.63%
A 1997	364,892	1.27%	452,703	0.77%
A 1998	373,083	2.24%	459,441	1.49%
A 1999	380,308	1.94%	468,417	1.95%
A 2000	387,583	1.91%	479,971	2.47%
A 2001	391,733	1.07%	479,444	-0.11%
A 2002	396,000	1.09%	482,021	0.54%
A 2003	399,667	0.93%	484,363	0.49%
F 2004	407,064	1.85%	492,247	1.63%
F 2005	415,583	2.09%	499,845	1.54%
F 2006	421,073	1.32%	504,743	0.98%
F 2007	426,450	1.28%	509,539	0.95%
1990-1996 average		3.26%		2.33%
1996-2002 average		1.59%		1.18%
2002-2007 average		1.24%		0.93%

Changes to State and Federal Tax Law

The simulation program calculates future tax liability for last year's full year resident returns assuming that individual line items grow as explained above. There are two types of adjustments that must be made to the program for each future year. One is to accommodate the fact that parts of both state and federal tax law, including rate tables and standard deductions, are indexed for inflation. The other is to accommodate changes in tax law. Significant changes in both state and federal tax law will take effect between CY 2003 and CY 2007. The changes in state law are the result of SB 407 (2003 session). Changes to federal tax law are the result of the Job Creation and Worker Assistance Act of 2002 (JCWAA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Changes to federal rate tables, deductions and credits are incorporated into the simulation program. The bonus depreciation provisions of JCWAA and JGTRRA affect the way that business income

is measured, not how it is taxed. Thus, an estimate of the impact of bonus depreciation was made separately and used to adjust the output of the simulation program.

The JCWAA and JGTRRA provide for temporary changes in business depreciation schedules. For depreciable equipment purchased between January 1, 2003 and May 5, 2003, the first year's depreciation is the amount from the normal depreciation schedule plus 30% of the original cost. Depreciation in the second year and for the rest of the asset's life is based on the normal schedule applied to the un-depreciated amount remaining after the first year. For equipment purchased between May 6, 2003 and December 31, 2004, businesses can choose between 30% and 50% extra depreciation in the first year. This does not change the total amount of depreciation that can be deducted in calculating a business's income. It just shifts depreciation to CY 2003 and CY 2004 from later years. Since depreciation is deducted from revenue in calculating income, bonus depreciation shifts income and taxes from CY 2003 and CY 2004 to later years.

The Department of Revenue examined depreciation schedules filed with three years of corporation license tax returns and recalculated tax liability for these returns as if bonus depreciation had been in effect for those years. The difference in liability was used to estimate the effect of bonus depreciation on both corporation license tax and business income reported on individual income tax returns. The right-hand column of Table 19 shows the estimated impact of bonus depreciation on income tax revenue in FY 2002 through FY 2007.

Table 19	
Revenue Impact of Bonus Depreciation	
Fiscal Year	Revenue Impact (\$ millions)
2002	(1.493)
2003	(2.526)
2004	(1.734)
2005	0.339
2006	1.833
2007	1.428

Calendar Year Tax Liability

The simulation program calculates tax liability for each return in the income tax database using the income and deductions reported on that return. For some returns, this is different from the tax liability reported on the return. The most common reason for this is that a few taxpayers attach copies of their federal returns rather than entering information on the income lines of their state returns. In the database, these returns appear to have no income so that their calculated tax liability is zero.

The first row of Table 20 shows calculated tax liability of \$534.044 million for CY 2003 full year resident returns and actual tax liability reported of \$540.969 million on

those returns. The left half of the second row shows calculated tax liability of \$561.533 million for CY 2004, which is a 5.15% change from CY 2003. The right half of the second row shows the growth rate of 5.15% applied to actual tax on CY 2003 full year resident returns to give forecast CY 2004 tax for full year residents of \$568.815 million. The remaining rows show the same calculation for CY 2005 through CY 2007.

Table 20				
CY 2004 - CY 2007 Tax Liability - Full Year Residents				
Calculated from CY 2003 Returns				
Calendar Year	Calculated Tax Liability		Actual 2003 Tax plus Growth	
	\$ million	% Change	\$ million	% Change
2003	534.044	-	540.969	-
2004	561.533	5.15%	568.815	5.15%
2005	536.080	-4.53%	543.032	-4.53%
2006	538.176	0.39%	545.155	0.39%
2007	545.789	1.41%	552.867	1.41%

Even though income is forecast to grow each year, calculated tax liability drops by 4.5% in CY 2005 because of the rate reductions in SB 407.

A regression model was estimated to determine the relationship between tax liability of all taxpayers and the liability of full year residents. The model that fit the data best predicts that in CY 2004 tax liability of all taxpayers will be \$25.126 million less than 111.30% of full year residents' liability and that the difference from 111.30% will increase by \$0.852 million each year. Table 21 shows the calculation of tax liability for all taxpayers for CY 2004 through CY 2007 based on CY 2003 returns.

Table 21						
CT 2004 - CY 2007 Tax Liability of All Taxpayers						
Calculated from CY 2003 Returns						
(\$ millions)						
Calendar Year	2003 Full Year Resident's Liability					All 2003 Taxpayers' Liability
F 2004	568.815	x	111.30%	-	-25.126	= 607.975
F 2005	543.032	x	111.30%	-	-25.978	= 578.427
F 2006	545.155	x	111.30%	-	-26.829	= 579.938
F 2007	552.867	x	111.30%	-	-27.681	= 587.670

Total tax liability for each year is the liability for all taxpayers based on CY 2003 returns, calculated in Table 21, adjusted for growth of returns, calculated from the growth rates in Table 18. Tax for each year is this liability minus credits. This is shown in Table 22.

<p align="center">Table 22 Calendar Year Tax Liability (\$ millions)</p>							
Year	Total Liability with Fixed Population		Ratio of Returns to 2003 Returns	Total Tax Liability	Home-owner / Renter Credit	Other Credits	Tax
F 2004	607.975	x	1.016	= 617.871	- 12.360	- 21.169	= 584.342
F 2005	578.427	x	1.032	= 596.916	- 12.706	- 22.096	= 562.114
F 2006	579.938	x	1.042	= 604.339	- 13.061	- 23.198	= 568.080
F 2007	587.670	x	1.052	= 618.215	- 13.427	- 24.321	= 580.468

The low-income homeowner renter credit is claimed on tax returns or on a separate form for persons who are not required to file income tax returns. The number of persons claiming this credit grew much faster in CY 2003 than in previous years. The number of people claiming the credit is forecast to grow at the average rate from CY 1996 through CY 2001. The average credit claimed is forecast to grow at the average rate from CY 1997 through CY 2003.

Two other credits are estimated individually. The credit for taxes paid to other states accounts for almost 75% of the amount of other credits. It has grown fairly steadily over time and is forecast to continue to grow by the average increase over CY 1990 through CY 2002. The credit for contributions to a charitable endowment is expected to be the largest other credit. HB 616 (2003 session) changed the percentage of a gift that can be claimed as a credit and the maximum credit. The credit is forecast by applying the percentage changes in the fiscal note for that bill to actual credits claimed in CY 2003. All other credits are forecast to grow at 6.53% per year, which is the average growth rate over the last five years with the effects of law changes removed.

Allocate Calendar Year Liability to Fiscal Years

It has been estimated that collections in a fiscal year are equal to 52.1% of collections in the current calendar year and 47.9% of collections in the previous calendar year. Table 23 shows the

<p align="center">Table 23 Fiscal Year Tax Liability</p>		
Fiscal Year	Tax Liability	Growth Rate
F 2004	563.594	
F 2005	572.761	1.63%
F 2006	565.223	-1.32%
F 2007	574.534	1.65%

calendar year tax liability calculated in Table 22 allocated to fiscal years and the annual growth rate. The drop in tax liability in CY 2005 is spread over two fiscal years, and there is minimal growth in calculated tax liability from FY 2004 to FY 2006.

Add Audit Revenue and Other Adjustments

The annual growth rates of fiscal year liability in Table 23 are applied to the latest actual fiscal year collections and then three adjustments are made to give the forecast of fiscal year collections. The first adjustment is for audit revenue and other collections that are not associated with tax returns. The second adjustment is for the effects of the federal bonus depreciation allowance. The third adjustment is for the transition to new tax rates under SB 407.

Table 24 shows the calculation of fiscal year collections. The first row shows actual FY 2004 collections of \$605.582 million in the sixth column. Audit revenue, penalty and interest and prior year payments were \$29.922 million, and bonus depreciation is estimated to have reduced revenue by \$1.734 million. Revenue before audit and adjustments, shown in the second column, is calculated by subtracting audit, penalty and interest, and prior year revenue from collections and adding back the revenue loss from bonus depreciation. The result, \$577.394 million, is used as the base for the forecast. Revenue before audit and adjustments for FY 2005 through FY 2007 is calculated by applying the growth rates in Table 23 to this base. Then, audit, penalty and interest, prior year revenue, the effect of bonus depreciation, and the SB 407 transition adjustment are added to give the forecast of collections, which is shown in the sixth column. Debt service payments for the Department of Revenue’s new data processing system are deducted from income tax collections. These are shown in the seventh column, and net revenue to the general fund is shown in the right-hand column.

Table 24													
Forecast Collections and Allocation													
(\$ millions)													
Fiscal Year	Revenue Before Audit and Adjustments	+	Audit, Penalty and Interest, Prior Year	-	Bonus Depreciation Adjustment	+	SB 407 Transition	=	Forecast Collections	-	DOR Debt Service	=	General Fund
A 2004	577.394	+	29.922	-	1.734			=	605.582	-	0.234	=	605.348
F 2005	586.785	+	21.400	+	0.339	+	8.019	=	616.543	-	1.276	=	615.267
F 2006	579.062	+	23.400	+	1.833	-	8.019	=	596.276	-	2.774	=	593.502
F 2007	588.602	+	28.400	+	1.428			=	618.430	-	3.183	=	615.247

The estimate of audit revenue is based on the Department of Revenue’s experience of revenue per auditor and the number of FTE expected to be devoted to auditing

income tax. Penalty and interest is expected to be proportional to audit revenue. Prior year revenue is projected to be constant at its FY 2004 level.

As explained above, bonus depreciation allows companies to shift profits from CY 2002, CY 2003, and CY 2004 to later years. The returns in the CY 2003 database incorporate the reduction in taxable income from bonus depreciation in CY 2003. Because of this, future tax liability calculated from CY 2003 returns understates tax liability by the difference in the effect of bonus depreciation. This is corrected by adding back the revenue loss in FY 2004 and then adding the revenue gain in later years. The adjustment increases through FY 2006 and then begins to decrease.

As shown in Table 5, SB 407 is expected to reduce tax liability by \$21.841 million in FY 2005. The Department of Revenue will implement new withholding tables January 1, 2005. The new withholding tables will reduce withholding by \$13.822 million in the last half of FY 2005. This is \$8.019 million less than the reduction in tax liability.

About two-thirds of income is from wages and salaries that are subject to withholding. The reduction in withholding is approximately equal to the reduction in tax liability from labor income. About one-third of income is from non-labor sources and is not subject to withholding. Taxpayers with significant amounts of non-labor income are required to make quarterly estimated tax payments or to have extra tax withheld from their labor income. Few taxpayers are likely to adjust their estimated payments or additional withholding for SB 407 until they have filed at least one tax return with the lower rates. Thus, the lower tax liability on non-labor income will not affect state revenue until tax returns are filed in the spring of 2006 and taxpayers with non-labor income request refunds that are \$8.019 million higher.

To adjust for the timing of the impact of SB 407 on non-labor income, collections are increased by \$8.019 million in FY 2005 and reduced by \$8.019 million in FY 2006.

Collections and Revenue

Collections are projected to increase by \$10.961 million (1.8%) in FY 2005, decrease by \$20.267 million (3.3%) in FY 2006, and increase by \$22.154 million (3.7%) in FY 2007. After deducting the Department of Revenue's debt service payments, income tax revenue to the general fund is projected to be \$615.267 million in FY 2005, \$593.502 million in FY 2006, and \$615.247 million in FY 2007.