

INDIVIDUAL INCOME TAX

Revenue Description

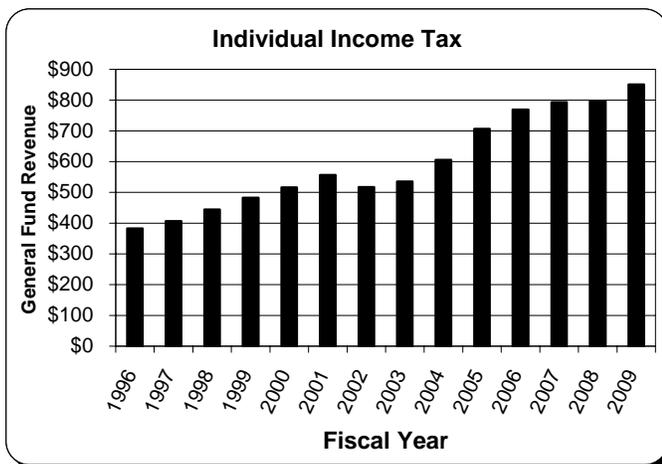
Title 15, Chapter 30, MCA, imposes a graduated individual income tax on gross income less exemptions and deductions. Taxpayers' Montana adjusted gross income is based on their federal adjusted gross income, but may be higher or lower because some types of income are taxed differently by the state and federal government. Itemized deductions for federal and state income tax are similar, except 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 ranged from 2% to 11% depending on taxable income. Beginning with tax year 2005, marginal rates ranged from 1% to 6.9%. Montana also allows a number of credits that may reduce taxpayers' liabilities. With the exception of FY 2005, all revenue from individual income tax is allocated to the general fund. About \$1.1 million of income tax revenue was allocated in FY 2005 to pay for the Department of Revenue's new data processing system.

Historical and Projected Revenue

Individual income tax is the single largest source of revenue to the general fund. In FY 2006, individual income tax revenue was 45% of total general fund revenue. Table 1 shows actual individual income tax revenue for FY 1996 through FY 2006 and forecast revenue for FY 2007 through FY 2009.

Table 1
Individual Income Tax Revenue
(\$ millions)

Fiscal Year	Collections	General Fund	Percent Change
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%
A 2005	\$707.327	\$ 706.219	16.66%
A 2006	\$768.912	\$ 768.912	8.88%
F 2007	\$793.826	\$ 793.826	3.24%
F 2008	\$797.002	\$ 797.002	0.40%
F 2009	\$851.073	\$ 851.073	6.78%



Income tax revenue grew fairly steadily from FY 1996 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 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 and 13% in FY 2004 as the national economy recovered and taxpayers realized the losses they had incurred in the stock market. Even with the rate reductions in SB 407 (2003 Session), revenue grew by 16.7% in FY 2005 and 8.9% in FY 2006 as the economy remained strong. Revenue is projected to increase by 3.24% in FY 2007. Revenue in FY 2008 is forecast to only grow by 0.4% as the capital gains tax credit effectively reduces the tax rate on capital gains from 5.9% to 4.9%. FY 2009 revenue is forecast to grow by 6.78%.

Background

Income tax collections through FY 2009 are affected by the projected growth of income, deductions, credits, changes to tax rates enacted in SB 407 (2003 Session), and changes in federal legislation.

SB 407 – New Rate Table

SB 407, which went into effect in tax year 2005, reduced income tax rates, provided a credit for part of capital gains income, and limited the itemized deduction for federal income taxes. Table 2 shows the rates for CY 2004, before SB 407, and the rates for CY 2005, the first year SB 407 was in effect. Under SB 407 there are fewer rates and lower minimum and maximum rates.

Table 2			
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		

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 deductions, but pay less than \$5,000 in federal income tax (\$10,000 if filing jointly). For taxpayers who pay more than \$5,000 in federal income tax (\$10,000 if filing jointly), the limited deduction for federal income tax means that their taxable income increases and so, therefore, does 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 overpaid federal taxes that year and receive a refund in the next year, then that refund must be reported as income for state income tax in the next year. 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) cannot be claimed as an itemized deduction and so does not reduce state income tax. Therefore, there is no state tax benefit from federal taxes paid over the cap. If the taxpayer receives a refund the next year, the refund is counted as state taxable income if it reduces the net amount paid (federal tax paid minus the refund) to below the cap. To illustrate, a married taxpayer filing jointly who paid \$11,000 in federal tax in CY 2005 can only claim \$10,000 as part of his itemized deductions. If the taxpayer receives a refund of \$100 in CY 2006 he would not have to report it as income (for state taxation) because it is less than the \$1,000 he could not claim as an itemized deduction. 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 for state taxation.

The tax benefit rule reduces taxable income and state 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.

SB 407 – Federal Alternative Minimum Tax

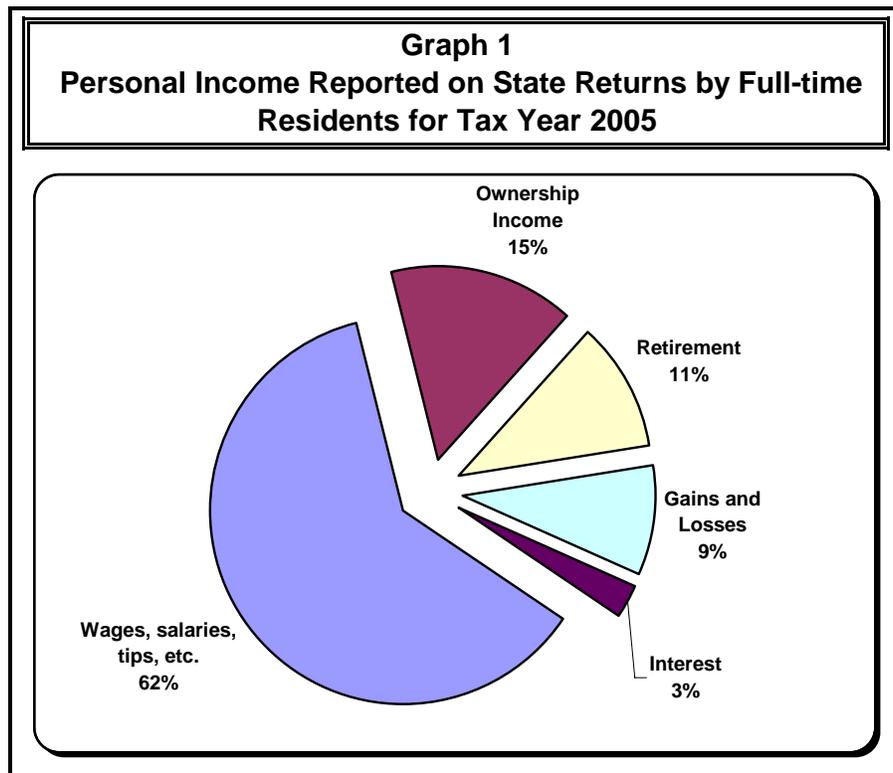
Recent federal legislation has raised the income level at which alternative minimum tax applies, but only through CY 2006. Therefore, under current law, the number of taxpayers paying federal alternative minimum tax will increase significantly in CY 2007, and these taxpayers will pay more federal income 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.

SB 407 – Capital Gains Credit

In CY 2005 and CY 2006, taxpayers are allowed to claim a tax credit equal to 1% of their capital gains income on their state income tax forms. 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.

Income by Category

Taxpayers can report income on eleven lines on the tax return. These income categories are forecast separately. These eleven income items can be organized into five general income categories for ease of understanding – wage, salary and tip income, ownership income, taxable retirement income, gains and losses, and interest. Graph 1 shows these categories and their relative proportion of total taxable income reported by full-time residents.



As can be seen from Graph 1, wages, salaries and tip income comprise the largest share of total reported income by full-time residents – almost three-fifths of income. Next is ownership income at 15%, then retirement income subject to taxation at 11%, followed by gains and losses at 9% of taxable income. Interest income comprises the smallest share of reported income by full-time residents at 3%.

Table 3 provides more detail on each income category by showing the amount of income reported for CY 2005 by full-year residents and the percent of total reported income that category represents for CY 2005. The last column in Table 3 also provides the average percent of total reported income for each category for the prior 10 years.

Table 3			
Calendar Year Income Reported by Full-Year Residents			
(\$ millions)			
Type of Income	CY 2005 Income	% of CY 2005 Income	% of CY 94- CY 04 Income
Labor Income			
Wages, salaries, tips, etc.	\$10,840.674	61.75%	65.22%
Ownership Income			
Rents, royalties, partnerships, etc.	\$1,704.629	9.71%	6.70%
Net business income	\$749.588	4.27%	4.78%
Dividend income	\$463.027	2.64%	2.48%
Net farm income	-\$125.935	-0.72%	-0.88%
Other income	-\$70.993	-0.40%	-0.25%
Retirement			
Taxable portion of Soc. Sec.	\$359.184	2.05%	1.72%
Taxable Pensions, IRAs	\$1,524.803	8.68%	8.55%
Gains and Losses			
Capital gain or (loss)	\$1,554.054	8.85%	6.83%
Supplemental gains or (losses)	\$77.631	0.44%	0.37%
Interest			
Interest income	\$480.088	2.73%	4.48%
TOTAL INCOME	\$17,556.750	100.00%	100.00%

Wages, salaries, tips, and other labor income reported by full-time residents was \$10,840.674 million in CY 2005, or about 62% of income reported by full-time residents. Over the period from 1994 through 2004 it accounted 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 averaged about 9.71% of income in FY 2005.
- Net business income is income that individuals receive from their direct ownership of a business. It averages about 4.27% of income.
- Dividends are income that individuals receive from owning shares of an incorporated business. Dividends averaged about 2.64% of income in CY 2005.

- 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 one of the other categories. 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 was 2.05% of reported income in CY 2005, up from the average of 1.72% during CY 1994 through CY 2004.
- Taxable retirement income from pensions, IRA distributions, and other sources except Social Security was 8.68% of income reported by full-time residents, up from an average of 8.55% of income during the period from CY 1994 through CY 2004.

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. In CY 2005 total gains and losses were over 9% of total reported income.

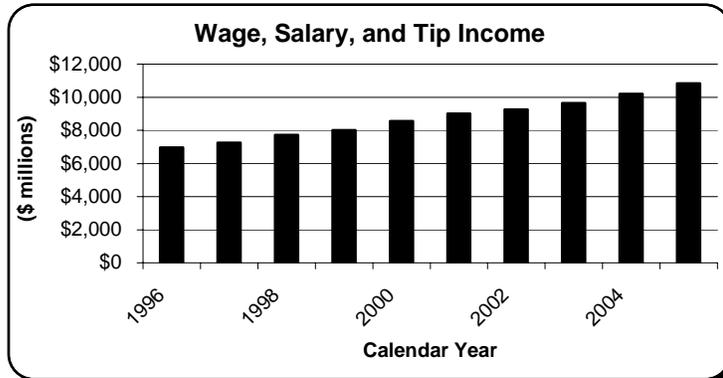
Interest averaged about 2.73% of income reported by full-time residents in FY 2005, down from the average of 4.48% of reported income for CY 1994 through CY 2004.

Wages and Salaries

Table 4 provides historical data on wage and salary income. Total wage and salary income reported by full-year residents grew by 6.18% in CY 2005, the third highest growth rate for the period CY 1996 through CY 2005.

Table 4
Wage, Salary and Tip Income Reported by Full-Year Residents
(\$ millions)

Calendar Year	Wage, Salary and Tip Income	Percent Change
A 1996	\$6,959.345	
A 1997	\$7,258.599	4.30%
A 1998	\$7,730.368	6.50%
A 1999	\$8,026.893	3.84%
A 2000	\$8,569.388	6.76%
A 2001	\$9,013.441	5.18%
A 2002	\$9,265.904	2.80%
A 2003	\$9,649.687	4.14%
A 2004	\$10,209.869	5.81%
A 2005	\$10,840.674	6.18%



Income growth results from increasing employment and average wages and salaries. Table 5 illustrates estimated employment growth as developed by Global Insight. The table shows the 16 employment categories, in decreasing order. The second column shows the percent of state employment in each sector in CY 2005. The third column shows average growth rate of employment in each sector from CY 1996 - CY 2005. The next four columns show forecast growth rates for CY 2006 through CY 2009. The final column shows the average forecast growth rates for CY 2007 through CY 2009.

Table 5
Employment Growth - Calendar Year

Industry	2005 % of Employment	Growth Rate					Average 2007 - 2009
		Average 1996- 2005	2006	2007	2008	2009	
State & Local Gov't (inc. Schools)	16.61%	1.1%	1.4%	1.3%	1.1%	1.2%	1.2%
Educational and Health Services	12.84%	2.1%	2.2%	1.8%	1.9%	1.7%	1.8%
Retail Trade	12.61%	0.6%	1.6%	1.5%	1.4%	1.0%	1.3%
Leisure and Hospitality	12.54%	1.2%	1.5%	1.5%	1.4%	1.0%	1.3%
Professional & Business Services	7.90%	2.7%	3.6%	3.7%	3.6%	3.4%	3.6%
Construction	6.24%	3.7%	8.3%	2.5%	1.0%	1.2%	1.6%
Financial Activities	4.87%	2.1%	2.1%	0.9%	1.2%	1.2%	1.1%
Manufacturing	4.43%	-1.0%	-0.3%	-0.5%	-0.3%	0.5%	-0.1%
Other Services	3.82%	1.6%	0.0%	1.3%	0.7%	0.5%	0.8%
Wholesale Trade	3.72%	0.6%	1.2%	0.7%	0.3%	0.3%	0.4%
Transport, Warehousing, Utilities	3.61%	-0.3%	2.7%	1.4%	1.1%	1.0%	1.2%
Federal Government	3.07%	0.4%	-1.0%	-0.2%	0.1%	0.4%	0.1%
Agriculture, Forestry, and Fishing	2.25%	0.2%	1.4%	1.1%	1.1%	1.0%	1.1%
Military	1.93%	-0.5%	-0.7%	0.2%	0.9%	1.0%	0.7%
Natural Resources and Mining	1.78%	1.6%	5.3%	5.6%	3.1%	-1.1%	2.5%
Information	1.77%	1.1%	-0.5%	1.3%	0.3%	1.3%	1.0%
Total Non-farm Employment Growth		2.0%	2.0%	1.6%	1.4%	1.2%	1.4%

Source: Global Insight Summer 2006 Montana.

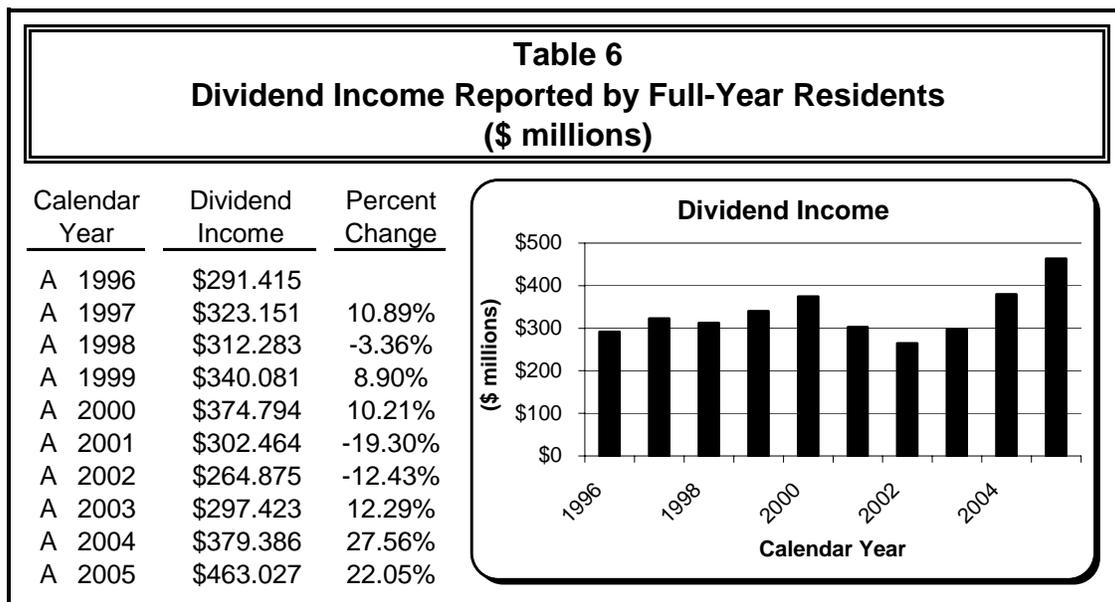
The fastest growing industries in CY 2007 through CY 2009 are projected to be professional and business services, natural resources and mining, and educational and health services. Manufacturing is the only industry projected to have a net job loss; however, the decline is small. Employment has grown faster than population in Montana as the fraction of the population doing paid work increased and the fraction of the population holding more than one job increased.

Wage and salary income is estimated in two steps. First, Global Insight's forecasts of Montana employment and average annual wages for major 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.

Total wage and salary income is forecast to grow at an average annual rate of 9.5% in CY 2006, by 4.91% in CY 2007, by 4.00% in CY 2008, and 4.31% in CY 2009. In CY 2004 and CY 2005 total wage and salary income grew by 5.81% and 6.18% respectively. By comparison total wage and salary income grew by an annual average of 5.25% during the period from CY 1991 through CY 2003. The individual base forecast growth rates are summarized in Table 14.

Ownership Income

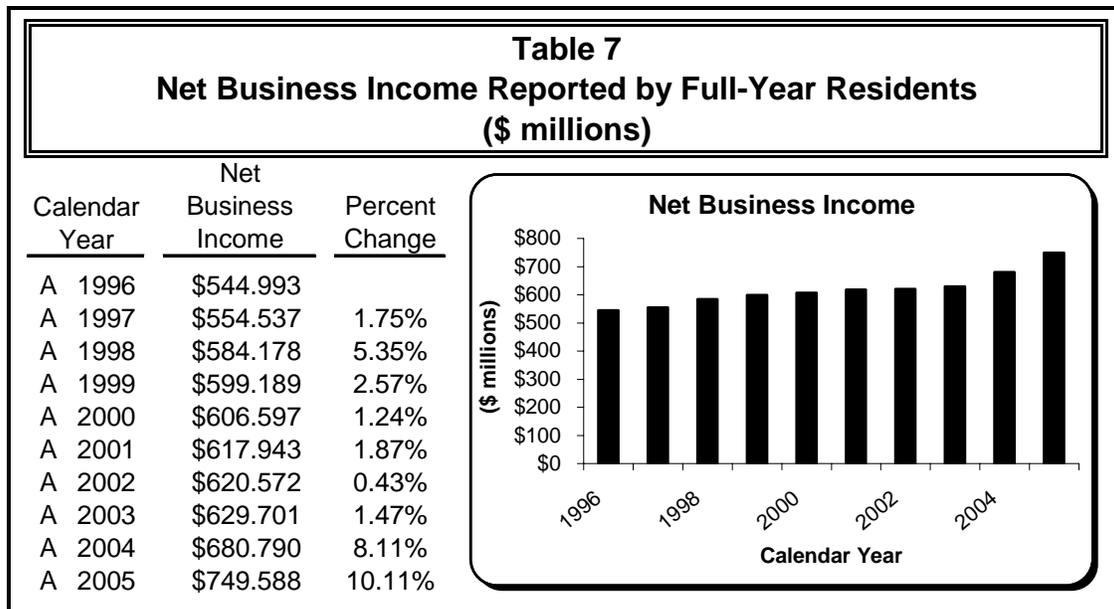
Table 6 shows dividends reported on full-year residents' income tax returns for CY 1996 through CY 2005.



Montana dividends and net business income are highly correlated with their national equivalents. Growth of Montana dividend income is forecast to be proportional 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. Dividend income increased by nearly 28% in CY 2004 and by 22% in CY 2005. Income from dividends is forecast to continue growing, but at a reduced rate during CY 2007 through CY 2009. The base forecast growth rates are summarized in Table 14.

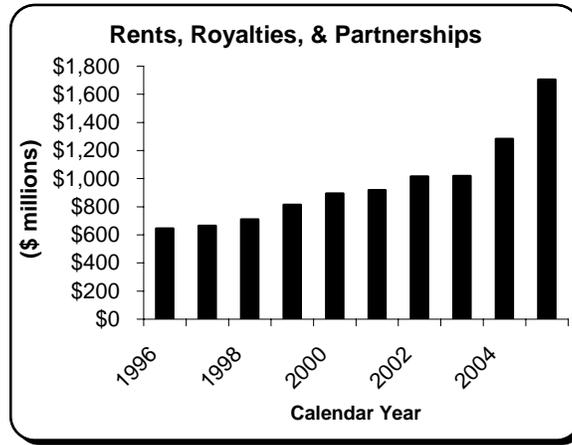
Net business income, shown in Table 7, is less volatile than dividends. The growth rate of Montana net business income is forecast based on the previous year's growth rate and the growth rate of national proprietors' income. Growth of net business income in Montana slowed in CY 2000 through CY 2002 as the national economy went into a recession. It remained at a relatively low rate of 1.47% in CY 2003. In CY 2004 it grew by 8.11% and in CY 2005 it grew by 10.11%. The base forecast growth rates are summarized in Table 14.



Rents, royalty, and partnership income is shown in Table 8. The growth rate of rents, royalties, and partnership income shows a strong relationship with national proprietors' income. In CY 2004 it grew nearly 26%. In CY 2005 it grew by 32.83%. It is forecast to continue to grow, but at a reduced rate from CY 2006 through CY 2009. Mineral royalties are generally reported in this category, and higher minerals, oil, and natural gas prices have contributed to this growth. The base forecast growth rates are summarized in Table 14.

Table 8
Rents, Royalties and Partnership Income Reported by Full-Year Residents (\$ millions)

Calendar Year	Rents, Royalties and Partnership Income	Percent Change
A 1996	\$645.596	
A 1997	\$664.947	3.00%
A 1998	\$709.340	6.68%
A 1999	\$813.250	14.65%
A 2000	\$894.050	9.94%
A 2001	\$917.394	2.61%
A 2002	\$1,014.593	10.60%
A 2003	\$1,019.724	0.51%
A 2004	\$1,283.271	25.84%
A 2005	\$1,704.629	32.83%



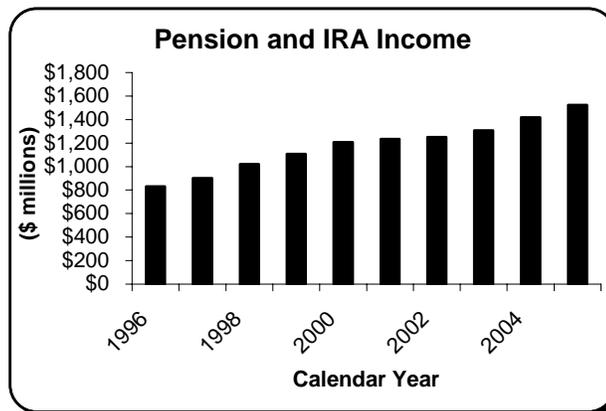
Net farm income has been negative in recent years and is projected to stay negative. Net farm income is forecast using forecasts of beef and wheat prices from the U.S. Department of Agriculture and a time trend. The other income line is a catchall for income that does not fit on the other lines. Other income is small and is forecast to grow at rate based on historic trends

Retirement Income

Table 9 shows actual taxable pension and IRA distributions for CY 1996 through CY 2005.

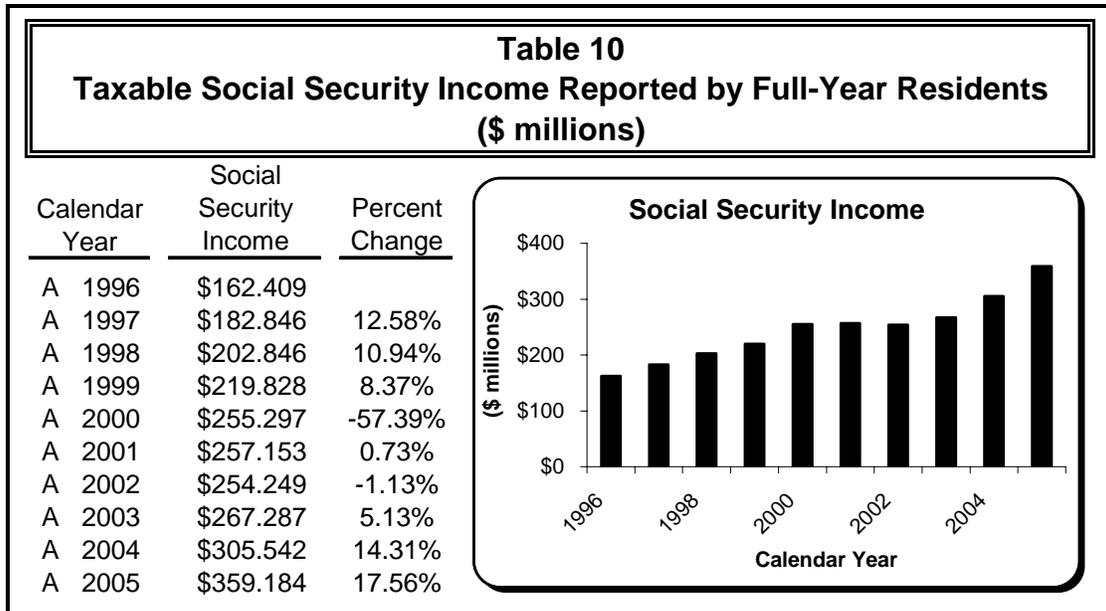
Table 9
Pension and IRA Income Reported by Full-Year Residents (\$ millions)

Calendar Year	Pension & IRA Income	Percent Change
A 1996	\$831.706	
A 1997	\$902.377	8.50%
A 1998	\$1,021.092	13.16%
A 1999	\$1,107.481	8.46%
A 2000	\$1,206.261	8.92%
A 2001	\$1,233.690	2.27%
A 2002	\$1,250.389	1.35%
A 2003	\$1,307.739	4.59%
A 2004	\$1,417.524	8.40%
A 2005	\$1,524.803	7.57%



Taxable pensions and IRA distributions have been found to have a good relationship with prior 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.

Table 10 shows historical data for taxable Social Security income. Taxable Social Security income is forecast based on inflation and Montana population age 65 and older. Table 14 shows the forecast growth rates for taxable retirement income and taxable Social Security.



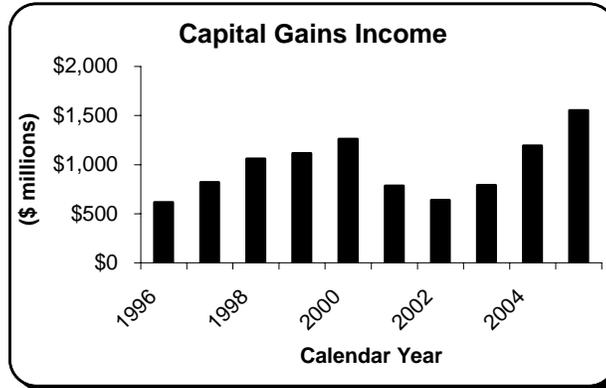
Capital Gains and Supplemental Gains

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 11 shows capital gains, in millions of dollars and percent change from year to year, from CY 1996 through CY 2005. As can be seen in Table 11, there is considerable variability in capital gains income with year-to-year changes (up or down) over this period.

Table 11
Capital Gains Income Reported by Full-Year Residents
(\$ millions)

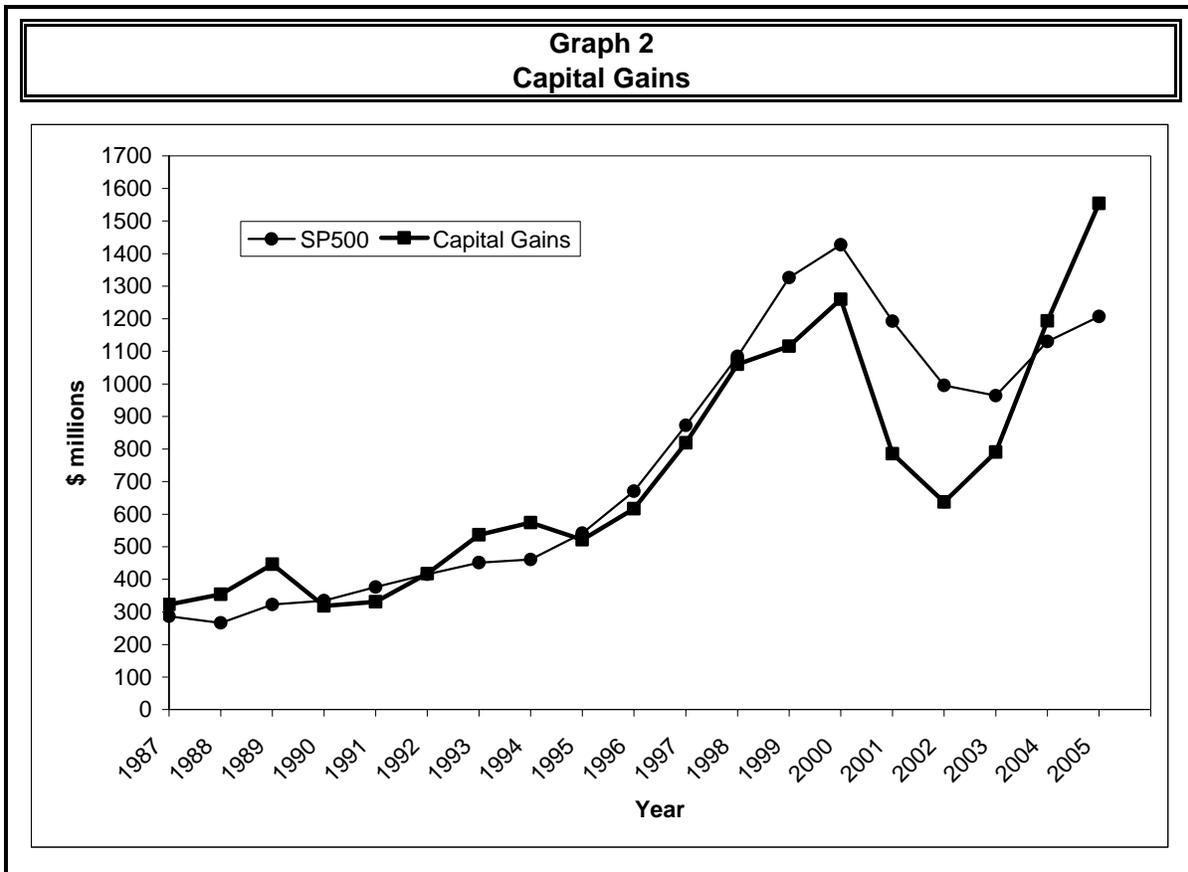
Calendar Year	Capital Gains	Percent Change
A 1996	\$616.453	
A 1997	\$818.544	32.78%
A 1998	\$1,060.174	29.52%
A 1999	\$1,115.780	5.25%
A 2000	\$1,259.720	12.90%
A 2001	\$785.759	-37.62%
A 2002	\$637.444	-18.88%
A 2003	\$790.913	24.08%
A 2004	\$1,193.177	50.86%
A 2005	\$1,554.054	30.25%



Capital gains followed a general upward trend from CY 1996 through CY 2000. During this period, capital gains doubled, growing 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. In CY 2003, CY 2004, and CY 2005 capital gains grew, with increases of 24%, 51%, and 30%, respectively.

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 have been 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.

Graph 2 shows actual capital gains in CY 1987 through CY 2005 and the actual average quarterly S&P 500 in CY 1987 through CY 2005.



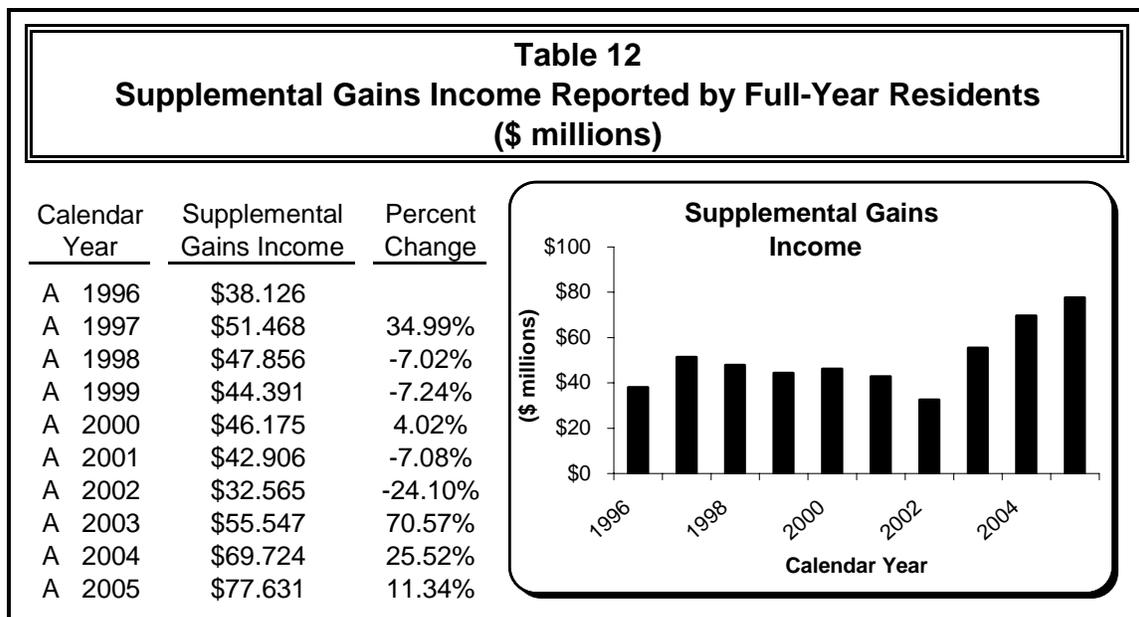
Through CY 1995, stock prices rose steadily. Capital gains varied from year to year, but had about the same average growth as stock prices. From CY 1996 through CY 1999, stock prices rose rapidly. Capital gains rose rapidly in CY 1997 and CY 1998 as many assets were sold for significantly more than was 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 were 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 were 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 began recovering and investors began selling some of the assets they bought during the trough in CY 2001 and CY 2002. Capital gains increased by 24%, but were still well below the long-term trend.

Stock prices rose sharply in CY 2004 and capital gains jumped by 51%. Capital gains increased by 30% in CY 2005. In addition to higher asset prices, capital gains in 2003, 2004, and 2005 were also affected by changes in federal law.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 included changes affecting long-term capital gains from sales on or after May 6, 2003, reducing the rates on many, but not all, types of gains from asset sales. The legislation included language which

sunset these lower capital gains rates in 2008 unless extended by Congress. In May 2006 Congress passed legislation extending the lower capital gains rates through 2010. In the past people with assets that have appreciated have responded to changes in capital gains rates by selling assets to realize gains during periods when rates are lower. This is almost certain to have happened again, and part of the increase in capital gains in 2003 through 2005 reflects a one-time turnover of assets following the rate cuts in order to realize the gains. In light of the extension of the lower rates in the 2006 federal legislation, and the inherent volatility exhibited by this revenue source, capital gains are forecast to remain constant through the period CY 2006 through CY 2009.

Supplemental gains follow similar cycles as capital gains with some differences. Table 12 shows the history for this revenue source for CY 1996 through CY 2005. The growth rates used to estimate supplemental gains are summarized in Table 14.

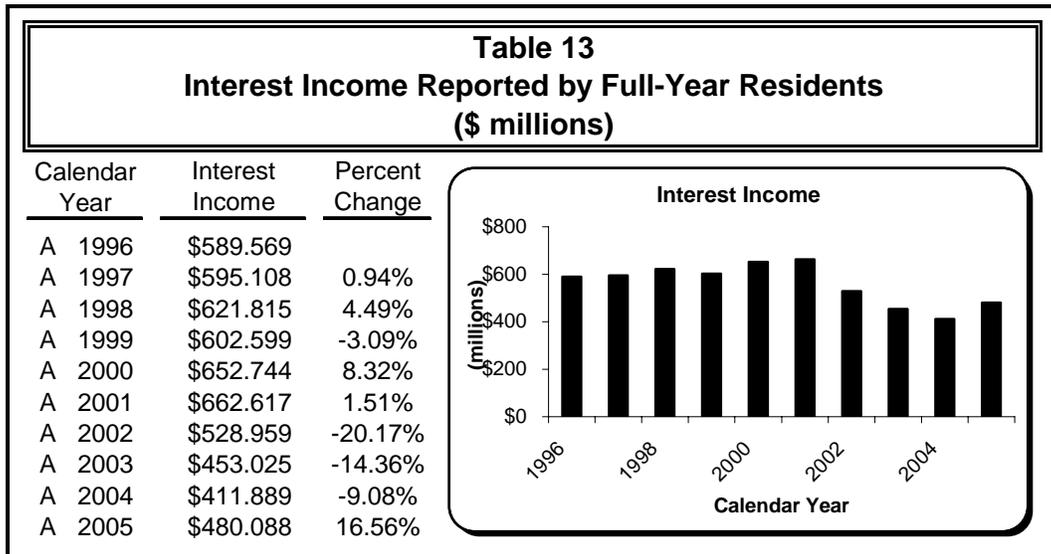


Interest Income

Interest earnings depend on taxpayers' savings and interest rates. Statistical models were used to find relationships among 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 13 shows actual interest income for CY 1996 through CY 2005. Interest income decreased by 20% in CY 2002 and 14% in CY 2003 as interest rates fell to historically low rates. Interest income continued to decline in CY 2004, as interest rates remained relatively low. In 2005 interest income rebounded as interest rates began to increase.

Table 14 shows that interest income is forecast to increase in the period from CY 2006 through CY 2009, in line with projected interest rate increases.



Adjustments to Income

A taxpayer's federal adjusted gross income is the sum of the eleven income categories just discussed, minus adjustments to income, which include unreimbursed expenses, IRA contributions, and alimony paid. Montana adjusted gross income is federal adjusted gross income plus income the state taxes but the federal government does not tax, minus income the federal government taxes but the state does not. Table 14 shows actual growth rates of adjustments to income and income that Montana taxes but the federal government exempts in CY 2001 through CY 2005 and forecasts for CY 2006 through CY 2009.

- Adjustments to income are forecast based on the most recent data.
- 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 additions.
- 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 an average growth rate from 1996 through 2005. 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. The other additions to income varies from year to year but shows no trend. It is projected to remain at the CY 2005 level.

Table 14 shows actual growth rates of income that Montana exempts but the federal government taxes in CY 2001 through CY 2005 and forecasts for CY 2006 through CY 2009. Income that the federal government taxes but Montana does not is reported in ten categories, but only nine are shown in Table 14.

- The farm risk management account and the health care professional loan payment exclusion are both relatively new items and so have little history on which to estimate future growth or levels. The farm risk management account exemption has shown wide swings in dollar amounts since it was created. The farm risk management account is projected to remain constant.
- The interest exclusion for the elderly is calculated for each return in the simulation program, so no overall growth rate is forecast.
- The exempt pension income is calculated for each return in the simulation program, so no growth rate is forecast.
- The interest on savings bonds forecast is based on interest rate forecasts provided by Global Insight.
- Unemployment compensation varies over the course of business cycles but does not show a trend. The forecast is for unemployment compensation to be constant at the CY 2005 level, reflecting the expectation that employment will remain strong.
- Medical savings account contributions are forecast to increase each year by the average dollar change of the CY 1997 through CY 2005 increases.
- Family education savings accounts are forecast to increase by the average dollar increase for CY 1996 through CY 2005.
- 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 2005.
- The health care profession loan payment exclusion has three years of history. The growth rate is based on the average growth rate since it was created.
- Other reductions are forecast to grow at the average 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 the following 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 SB 407 limits on this deduction.
5. Deductions for real estate taxes are based on the average growth rate from CY 1996 through CY 2005.
6. Deductions for vehicle taxes are based on the average growth rate from CY 1996 through CY 2005.
7. Mortgage interest deductions are forecast using the average growth rate from CY 1996 through CY 2005.
8. Deductions for investment interest are forecast using the interest rate on three-month certificates of deposit.
9. Deductions for charitable contributions are forecast using a trend and the forecast population, 19 years and older, in Montana.
10. Deductions for child and dependent care expenses are forecast using the average growth rate from CY 1996 through CY 2005.
11. Deductions for casualty and theft losses are forecast to grow by the average growth in recent years.
12. Deductions in the first miscellaneous category are forecast to grow by the average growth in CY 1996 through CY 2005.
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 using the average growth rate from CY 1999 through CY 2004.

Table 14 shows actual growth rates of itemized deduction for CY 2001 through CY 2005 and forecasts for CY 2006 through CY 2009.

Forecast Methodology and Projection Calculation

The process of estimating income tax revenue is based on 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. The program 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. This process is repeated, growing income and deductions and calculating tax liability, for each year of the forecast.

Before the program is run, growth rates for income and deductions must be estimated 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.

Once the simulation program has estimated future years' tax liability for full-year resident taxpayers who filed in the past year, a number of additional steps must be taken in order to produce projected fiscal year collections for all filers. These additional steps include adjusting for projected population growth; changes to state and federal tax law; adjustments for calendar year tax liability, additional revenue from less than full-time residents; reduced revenue due to credits; conversion from calendar year to fiscal year collections; and accounting for revenue from audits, penalties and interest, and other adjustments such as additional refunds.

The entire estimation process can be divided into seven steps:

1. Forecast growth rates for income categories, deductions, and number of taxpayers.
2. Divide income and deduction growth by the estimated number of taxpayers to give per capita growth.
3. Incorporate changes in state and federal law and forecast inflation in the program calculating future years' tax liability.
4. Calculate tax liability in CY 2007 through CY 2009 for full-year residents who filed a return for CY 2005 assuming that their income and deductions line items grow as forecast. Adjust the future tax liability of CY 2005 full-year filers for the percent 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 liability to fiscal year tax liability.
7. Make legislative, audit, and any other adjustments to determine the final estimates of fiscal year revenue.

Forecast Growth Rates

Table 14 provides a summary of the projected growth rates used in the simulation model from income items, itemized deductions, and credits for CY 2006 through CY 2009. A number of different sources combine to provide the growth rate forecasts shown in Table 14. These include economic forecasts from Global Insight; information from the Bureau of Economic Analysis, U. S. Department of Commerce; commodity price forecasts from the Economic Research Service (USDA); historical trends from prior year data; estimated impacts of recent related legislation; population forecasts; and other sources.

Table 14

Historic and Projected Growth Rates for Line Items

INCOME ITEMS	Historical Rates					Projected Rates			
	CY 2001	CY 2002	CY 2003	CY 2004	CY 2005	CY 2006	CY 2007	CY 2008	CY 2009
FEDERAL AGI ITEMS									
Wages, salaries, tips, etc.	5.18%	2.80%	4.14%	5.81%	6.18%	9.50%	4.91%	4.00%	4.31%
Interest income	1.51%	-20.17%	-14.36%	-9.08%	16.56%	7.85%	5.51%	6.80%	9.98%
Dividend income	-19.30%	-12.43%	12.29%	27.56%	22.05%	11.19%	11.70%	10.90%	8.67%
Net business income	1.87%	0.43%	1.47%	8.11%	10.11%	1.53%	2.26%	2.63%	1.71%
Capital gain or (loss)	-37.62%	-18.88%	24.08%	50.86%	30.25%	0.00%	0.00%	0.00%	0.00%
Supplemental gains or (losses)	-7.08%	-24.10%	70.57%	25.52%	11.34%	-1.58%	-2.30%	-2.88%	-3.43%
Rents, royalties, partnerships, etc.	2.61%	10.60%	0.51%	25.84%	32.83%	10.12%	8.74%	9.00%	13.61%
Taxable IRAs and pensions	2.27%	1.35%	4.59%	8.40%	7.57%	7.22%	7.77%	5.38%	6.39%
Taxable portion of Soc. Sec.	0.73%	-1.13%	5.13%	14.31%	17.56%	11.66%	2.53%	2.55%	2.21%
Net farm income	-45.38%	-39.86%	7.18%	4.51%	9.80%	21.97%	14.41%	11.16%	7.40%
Other income	-1.48%	6.45%	-20.06%	-7.02%	-3.32%	-10.79%	-9.74%	-8.87%	-8.15%
Adjustments to Income	1.28%	23.21%	15.69%	7.28%	7.28%	7.27%	7.27%	7.27%	7.26%
ADDITIONS:									
Interest on state, county, bonds	4.78%	-2.97%	4.01%	6.47%	7.14%	-2.71%	4.11%	-14.22%	-11.98%
Federal income tax refunds	10.24%	21.34%	3.88%	5.72%	-7.04%	8.59%	8.59%	8.59%	8.59%
Other additions	0.73%	2.63%	18.14%	15.70%	-25.27%	0.00%	0.00%	0.00%	0.00%
REDUCTIONS:									
Farm risk management account	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Elderly interest exclusion	0.09%	-7.40%	-7.41%	-5.24%	4.97%	na	na	na	na
Exclusion for savings bonds	-12.81%	-30.61%	-20.93%	-7.70%	12.93%	23.30%	1.91%	1.41%	5.13%
Exempt pension income	3.30%	2.98%	0.96%	0.96%	0.96%	na	na	na	na
Unemployment income	17.40%	31.53%	9.50%	-21.39%	-16.24%	0.00%	0.00%	0.00%	0.00%
Medical savings account excl.	21.63%	20.56%	14.70%	21.74%	3.43%	11.65%	10.43%	9.45%	8.63%
Family education account excl.	61.24%	60.42%	20.15%	13.52%	-6.55%	12.44%	11.06%	9.96%	9.06%
First-time homebuyers acct. excl.	23.47%	1.76%	14.94%	-18.84%	4.42%	4.42%	4.42%	4.42%	4.42%
Other reductions	6.46%	5.44%	6.83%	10.51%	12.06%	7.00%	7.00%	7.00%	7.00%

**Table 14
Historic and Projected Growth Rates for Line Items (continued)**

ITEMIZED DEDUCTIONS:	Historical Rates					Projected Rates			
	CY 2001	CY 2002	CY 2003	CY 2004	CY 2005	CY 2006	CY 2007	CY 2008	CY 2009
Medical insurance premiums	8.97%	9.89%	-1.99%	7.25%	6.03%	5.53%	5.53%	5.53%	5.53%
Medical deduction	9.95%	9.71%	6.12%	9.27%	5.73%	8.05%	8.05%	8.05%	8.05%
Long-term care insurance	4.14%	12.98%	8.86%	6.81%	3.53%	6.83%	6.39%	6.01%	5.67%
Balance of federal tax	2.51%	-2.55%	-5.09%	-11.00%	5.21%	1.86%	0.00%	0.00%	0.00%
Additional federal tax	61.28%	-31.92%	17.64%	0.55%	-20.23%	1.42%	1.42%	1.42%	1.42%
Property taxes	3.70%	10.66%	5.99%	7.44%	0.05%	4.56%	4.56%	4.56%	4.56%
Motor veh. and other deductible taxes	-18.12%	11.63%	3.00%	10.16%	26.69%	6.05%	6.05%	6.05%	6.05%
Home mortgage interest	7.03%	4.15%	-1.05%	4.24%	9.81%	6.57%	6.57%	6.57%	6.57%
Deductible investment interest	-9.45%	-22.57%	-12.23%	12.34%	38.17%	4.15%	-0.48%	-0.60%	0.27%
Contributions	3.57%	13.05%	-2.26%	11.23%	6.55%	3.82%	2.79%	2.47%	2.23%
Child/dependent care expenses	-7.59%	1.57%	2.18%	-9.36%	-3.22%	-3.10%	-3.10%	-3.10%	-3.10%
Casualty and theft losses	-56.20%	41.33%	-8.03%	-11.86%	23.74%	0.15%	0.15%	0.15%	0.15%
Tier I - Miscellaneous	9.07%	3.81%	0.45%	9.13%	8.53%	6.79%	6.79%	6.79%	6.79%
Tier II - Miscellaneous	-0.26%	13.45%	67.50%	-31.04%	7.25%	6.76%	3.01%	3.01%	3.01%
Gambling Losses	-14.98%	0.14%	-3.55%	22.97%	28.25%	8.34%	8.34%	8.34%	8.34%

CREDITS

Capital gains tax credit						0.00%	0.00%	0.00%	0.00%
Elderly homeowner/renter tax credit	\$284,082	\$405,666	\$338,643	\$336,829	\$7,853,725	13.40%	5.00%	4.77%	4.55%
Physician credit for rural practice	\$165,451	\$166,369	\$148,470	\$171,903	\$252,400	10.11%	4.89%	11.23%	10.10%
College contribution credit	\$7,410,957	\$1,610,509	\$2,138,608	\$2,502,605	\$206,886	10.11%	4.89%	11.23%	10.10%
Charitable endowment credit	\$64,247	\$27,493	\$21,041	\$27,911	\$2,491,431	10.11%	4.89%	11.23%	10.10%
Elderly care credit	\$13,501,613	\$14,013,510	\$14,479,498	\$17,407,297	\$55,257	10.11%	4.89%	11.23%	10.10%
Other state/foreign tax credit	\$649,632	\$613,178	\$776,635	\$804,843	\$18,854,161	10.11%	4.89%	11.23%	10.10%
Contractor's gross receipts credit	\$4,765	\$1,756	\$300,489	\$445,967	\$1,024,102	10.11%	4.89%	11.23%	10.10%
Investment credit	\$40,193	\$228,283	\$2,440,965	\$3,098,479	\$640,431	10.11%	4.89%	11.23%	10.10%
Alternative energy systems credit	\$201,445	\$1,305,788	\$11,174	\$16,982	\$5,623,446	10.11%	4.89%	11.23%	10.10%
Energy conservation credit	\$3,220	\$3,312	\$11,174	\$16,982	\$11,090	10.11%	4.89%	11.23%	10.10%
Alternative energy production credit	\$102,071	\$66,369	\$121,309	\$307,678	\$410,815	10.11%	4.89%	11.23%	10.10%
Recycling credit	\$2,924	\$8,845			\$25,283	10.11%	4.89%	11.23%	10.10%
Alternative fuels credit	\$170,001	\$159,288			\$49	10.11%	4.89%	11.23%	10.10%
Montana capital company credit	\$338	\$3,897	\$8,484	\$6,208	\$8,818	10.11%	4.89%	11.23%	10.10%
Employee care assistance credit	\$93,618	\$61,113	\$137,398	\$427,460	\$517,110	10.11%	4.89%	11.23%	10.10%
Infrastructure users fee credit	\$0	\$0	\$17,810	\$97,748	\$851,766	10.11%	4.89%	11.23%	10.10%
Historic building preservation credit	\$71,980	\$74,777			\$51,297	10.11%	4.89%	11.23%	10.10%
Developmental disability account credit				\$1,050	\$2,715	10.11%	4.89%	11.23%	10.10%
Empowerment zone credit				\$365	\$969	10.11%	4.89%	11.23%	10.10%
Other Credits	\$901,516	\$194,885	\$178,460	\$808,488	\$8,937,198	10.11%	4.89%	11.23%	10.10%

Population Growth

The simulation program estimates future years' tax liability for taxpayers who filed returns for the most recent tax year. However the number of taxpayers does not stay constant in future years; growth in the number of taxpayers must be taken into account. Table 15 shows the number of full-year resident returns for CY 1996 through CY 2005 and projections for CY 2006 through CY 2009. This variable is modeled to determine the population adjustment used for tax returns.

Table 15			
Full-Year Resident Tax Returns			
Calendar Year	Tax Returns	% chg.	Model Population Adjustment
A 1996	449,231	1.63%	na
A 1997	452,703	0.77%	na
A 1998	459,441	1.49%	na
A 1999	468,417	1.95%	na
A 2000	479,971	2.47%	na
A 2001	479,444	-0.11%	na
A 2002	482,021	0.54%	na
A 2003	484,363	0.49%	na
A 2004	491,463	1.47%	na
A 2005	497,453	1.22%	1.000
F 2006	504,537	1.42%	1.024
F 2007	511,621	1.40%	1.049
F 2008	518,705	1.38%	1.074
F 2009	525,790	1.37%	1.098

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 forecast in Table 14. 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 reflect certain changes in state and federal tax law. 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), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and the Tax Increase Prevention and Reconciliation Act of 2005. Changes to federal rate tables, deductions, and some credits are incorporated into the simulation program. Certain other changes are made after the model is run to reflect known and estimated changes due to state legislation.

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, the calculated tax liability is different from the tax liability reported on the return. The most common reason for this is taxpayers attaching 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. Table 16 shows the calculated tax liability and forecast growth rate for CY 2006 through CY 2009.

Table 16 CY 2005 - CY 2009 Tax Liability - Full-Year Residents Calculated from CY 2005 Returns		
Calendar Year	Calculated Tax Liability	
	\$ million	% Change
A 2005	652.519	-
F 2006	696.881	6.80%
F 2007	708.409	1.65%
F 2008	728.761	2.87%
F 2009	761.702	4.52%

The simulation model develops the estimated tax liability for taxpayers who are full-time residents. Total tax liability for each year is estimated by: (1) adjusting the CY 2005 tax liability for all full-time resident taxpayers for population and (2) multiplying the full-time resident taxpayer liability by 108.6%, to include nonresident or part-time resident tax liability.

Table 17 shows the results of the calculation of tax liability for all taxpayers for CY 2007 through CY 2009 based on CY 2005 returns.

Table 17 CY 2005 - CY 2009 Tax Liability of All Taxpayers Calculated from CY 2005 Returns (\$ millions)					
Calendar Year	FY 2005 Full Year Resident's Liability	Model Population Adjustment	Population Adjusted Liability	Non-resident Adjustment	All Taxpayers' Liability
A 2005	\$652.519	1.000	652.519	1.086	\$708.650
F 2006	\$696.881	1.024	713.884	1.086	\$775.294
F 2007	\$708.409	1.039	735.895	1.086	\$799.197
F 2008	\$728.761	1.053	767.459	1.086	\$833.476
F 2009	\$761.702	1.068	813.117	1.086	\$883.062

Deduct Income Tax Credit

Total tax liability for each year is all taxpayer's tax liability minus tax credits. Table 18 shows the projected tax liability after tax credits are deducted.

The low-income homeowner renter credit has grown relatively steadily over the last decade. The average credit claimed is forecast to grow at the average rate of growth from CY 2001 through CY 2005.

Other credits are estimated as a group based on the average growth rate from CY 2001 through CY 2005, but with an adjustment for the credit for contributions to a charitable endowment which sunsets at the end of CY 2007. Table 14 provides more detail on the historical values of individual credits.

Table 18
Calendar Year Tax Liability After Credits
(\$ millions)

Calendar Year	Total Liability before Credits	Home-owner / Renter Credit	Other Credits	Tax
A 2005	\$708.650	- \$11.580	- \$32.958	= \$664.112
F 2006	\$775.294	- \$13.132	- \$36.290	= \$725.871
F 2007	\$799.197	- \$13.790	- \$38.065	= \$747.343
F 2008	\$833.476	- \$14.447	- \$42.340	= \$776.690
F 2009	\$883.062	- \$15.104	- \$46.614	= \$821.343

Allocate Calendar Year Liability to Fiscal Years and Adjust for Extraordinary Refunds

Shown in Table 19 is the extraordinary refund adjustment. In October 2006 (FY 2007), refunds were \$24 million larger than in October of 2005 (FY 2006). These refunds were made for CY 2005 tax liability; and thus, the FY 2006 revenues reflect payments made, but not related to the actual tax liability. The assumption is that the extraordinary refunds were due to overpaying estimated payments in FY 2006 because of the tax changes in SB 407.

Table 19
Fiscal Year Tax Liability Adjusted for Additional Refunds
(\$ millions)

Fiscal Year	Tax Liability	Adjustment	Adjusted Tax Liability
F 2006	\$747.435	\$24.000	\$723.435
F 2007	na	0.000	\$765.065
F 2008	na	0.000	\$790.990
F 2009	na	0.000	\$829.699

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 20 Fiscal Year Tax Liability (\$ millions)		
<u>Fiscal Year</u>	<u>Tax Liability</u>	<u>Growth Rate</u>
F 2006	\$723.435	5.86%
F 2007	\$765.065	3.47%
F 2008	\$790.990	3.47%
F 2009	\$829.699	4.89%

Make Legislation, Audit, and Other Adjustments

Four 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 estimated audit revenue is from the Department of Revenue.

The second adjustment is for legislative changes in the 2005 Session. As shown in Table 21, three bills passed in the 2005 Session change the individual revenue estimate by \$3 million in FY 2007 and \$3.6 million in FY 2008 and FY 2009.

Table 21 2005 Session Legislation Impacts of Individual Income Tax Revenue Estimates				
<u>Bill #</u>	<u>Short Title</u>	<u>FY 2007</u>	<u>FY 2008</u>	<u>FY 2009</u>
HB 439	Disallow double credit for foreign income tax payment	\$369,000	\$369,000	\$369,000
HB 667	Purchasing pools, tax credit for health insurance	(\$3,349,000)	(\$3,950,276)	(\$3,950,286)
SB 340	Builder allowed tax credit for residential geothermal systems	(\$45,000)	(\$45,000)	(\$45,000)
2005 Session Legislation Impacts		(\$3,025,000)	(\$3,626,276)	(\$3,626,286)

The third adjustment, shown in Table 22, reflects the effect of the tax benefit rule enacted as part of SB 407 (2003 Session) which created a new cap on the amount of federal income tax that can be deducted. The fourth adjustment, also shown in Table 22, is for the second capital gains credit enacted as part of SB 407. The allowed credit for capital gains increases to 2% in FY 2007.

As shown in Table 22, individual income tax is projected to be \$793.826 million in FY 2007, \$797.002 million in FY 2008, and \$851.073 million in FY 2009.

Table 22
Forecast Individual Income Tax Revenue
(\$ millions)

Fiscal Year	Revenue Before Audit and Adjustments	Audit, Penalty and Interest, Prior Year	Adjustment for Prior Year Legislative Changes	SB 407 Tax Benefit Rule	Capital Gains Credit	Adjusted Forecast Collections
A 2005	\$670.086	+ \$37.240	+ \$0.000	+ \$0.000	+ \$0.000	= \$707.327
F 2006	\$723.435	+ \$22.744	+ \$0.000	+ \$0.000	+ \$0.000	= \$746.178 ¹
F 2007	\$765.065	+ \$25.000	+ (\$3.025)	+ (\$7.975)	+ \$15.362	= \$793.826
F 2008	\$790.990	+ \$25.000	+ (\$3.626)	+ \$0.000	- \$15.362	= \$797.002
F 2009	\$829.699	+ \$25.000	+ (\$3.626)	+ \$0.000	+ \$0.000	= \$851.073

¹ Refunds given in October 2006 for the CY 2005 individual income tax liability were approximately \$24 million higher than the prior year October refund level. Due to the tax reduction in CY 2005, this forecast assumes there were overpayments of estimated taxes in FY 2006 which resulted in over collection of revenues.

Data Sources

Revenue data is from SABHRS and the Department of Revenue. Estimated audit revenue for future years is from the Department of Revenue. Past employment and wage data is from the Bureau of Labor Statistics, U.S. Department of Labor. Commodity market estimates for future years is from the Economic Research Service, U.S. Department of Agriculture. Inflation estimates used in estimating certain future tax bracket and other tax data were from the Congressional Budget Office. Employment, wage, interest rates, and other economic data forecasts are from Global Insight's October 2006 forecast.