

INDIVIDUAL AND CORPORATE INCOME TAXES

BIENNIAL REPORT • MONTANA DEPARTMENT OF REVENUE



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|--|--|
| 54 Overview of Individual Income Tax | 72 Comparison of State Corporate Tax Rates |
| 55 Recent Legislative Changes to Individual Income Tax | 73 Overview of Pass-Through Entities |
| 56 Calculation of Individual Income Tax | 75 Growth of Pass-Through Entities |
| 57 Income, Deductions, Credits and Tax | 77 Pass-Through Entity Returns |
| 65 Overview of Corporate License Tax | 80 Tax Administration of Pass-Through Entities |
| 71 Estimated Payments, Penalties and Interest | |

Overview of Individual Income Tax

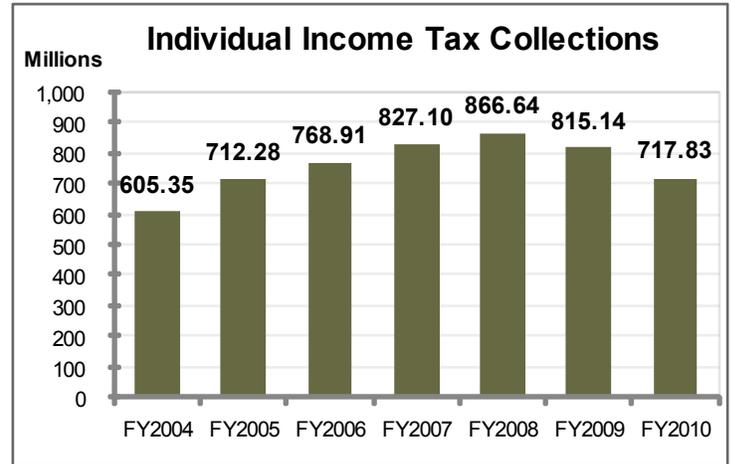
Montana's individual income tax was enacted in 1933 and is the largest source of state tax revenue. The state's income tax has a graduated rate structure with rates ranging from 1% to 6.9% of taxable income. This makes it a "progressive" tax because taxpayers with higher incomes pay a higher percentage of their income in tax.

Like most of the 43 states with an income tax, Montana has tied its income tax very closely to the federal income tax. Montana law defines taxable income largely by reference to federal definitions of income and deductions, and Montana income tax returns rely heavily on information from federal income tax returns. This reduces the department's costs of administering the income tax and taxpayers' costs of complying with the income tax.

Montana's income tax does differ from the federal income tax in several ways, primarily in additions to and reductions from federal adjusted gross income, unique itemized deductions, and tax credits. Most of these differences reflect legislative policy decisions while a few are due to federal limits on state taxation.

Individual Income Tax Collections	
FY2004	\$605,348,421
FY2005	\$712,280,615
FY2006	\$768,911,933
FY2007	\$827,095,302
FY2008	\$866,638,122
FY2009	\$815,138,193
FY2010	\$717,834,371

Montana is one of few states that allows a deduction for federal income taxes, but the deduction is capped at \$5,000 (\$10,000 for married couples filing jointly). Montana also is one of few states that allows married couples to file separate state returns even if they file a joint federal return. This reduces household tax liability and eliminates any "marriage penalty" at the state level.



Since 1981, Montana's individual income tax – including the standard deduction, personal exemptions, and tax rate table brackets – has been adjusted annually for inflation. This prevents increases in tax liability that would otherwise occur due simply to inflation.

Income tax revenues are collected primarily through employer withholding, quarterly estimated tax payments, and payments made when a return is filed. Income tax revenues are distributed 100% to the state general fund.

Income Tax Returns and Refunds				
Timely Filed Current Year Returns				
Calendar Year	Returns	Returns with Refund	Percent with Refund	Average Refund
1999	516,658	254,686	61%	\$351
2000	529,937	266,152	62%	\$376
2001	529,955	279,641	65%	\$413
2002	532,617	287,843	67%	\$415
2003	536,100	288,154	66%	\$405
2004	547,623	294,025	66%	\$468
2005	554,224	297,993	66%	\$491
2006	572,256	311,789	66%	\$464
2007	591,874	345,972	71%	\$506
2008	601,078	345,172	70%	\$598
2009	587,425	337,714	70%	\$545

Recent Legislative Changes to Individual Income Tax

The following bills passed by the 2009 Legislature affected the individual income tax:

House Bill 21 makes permanent the credit for a portion of the cost of investment in property used to collect or process reclaimable material and the extra deduction for 10% of a business's costs of buying recycled material. Previously, these tax incentives were set to expire at the end of 2011.

House Bill 163 extended the sunset date for credits for film and television production in Montana from the end of 2009 to the end of 2014.

House Bill 262 made changes to the credit for installing an alternative energy system in the taxpayer's principal residence. It limited the credit to heating systems, and it made masonry heaters and outdoor hydronic heaters that meet certain standards eligible for the credit.

House Bill 315 requires that the partial exemption for pension and annuity income be adjusted for inflation each year beginning in 2010.

House Bill 636 exempts part or all of the gain from selling a mobile home park to a tenants' or residents' association, a non-profit that buys the park on behalf of the residents, or a municipal or county housing authority. For a park with 50 or fewer lots, the full gain is excluded from income. For a park with more than 50 lots, half the gain is excluded.

Senate Bill 135 makes one change to the Insure Montana credit for small businesses that begin providing group health insurance for employees. Previously, an employer was ineligible if any employee who was not a part-owner was paid wages of more than \$75,000 per year. This bill prevents any part-owner of an eligible business who is paid wages of more than \$75,000 per year from claiming the credit.

Senate Bill 181 requires proceeds from the sale or exchange of real estate to be reported to the Department of Revenue whenever they are required to be reported to the IRS on a Form 1099-S.

Senate Bill 260 allows publicly traded partnerships to file annual information returns showing partners who received Montana source income in lieu of the normal requirement for a pass-through entity to either pay tax on behalf of its owners or file a form showing that the owners agree to pay tax themselves.

Senate Bill 418 increases the limit on income that a person can earn and be claimed as another's dependent from \$800 to the personal exemption amount. It also allows a taxpayer who the IRS has relieved from liability for their spouse's understatement of tax liability to apply to the department for the same relief.

Calculation of Individual Income Tax

Calculation of Montana individual income tax begins with the taxpayer's **Federal Adjusted Gross Income**.

Several adjustments are made to give **Montana Adjusted Gross Income**:

- Income taxed by the state but exempted by the federal government is added,
- Income exempted by the state but taxed by the federal government is subtracted,
- Deposits to Montana tax-advantaged savings accounts are subtracted,
- Taxable withdrawals from Montana tax-advantaged savings accounts are added,
- Net adjustments from filing a joint federal return and separate state returns are added, and
- Recoveries of costs deducted in previous years (primarily refunds of federal taxes previously deducted) are subtracted.

Any **credits** the taxpayer may claim are subtracted from the tax liability to give the net tax.

- Taxpayers with capital gains income are allowed a credit equal to 2% of their capital gains. In effect, this taxes capital gains at a lower rate than other income.
- Other credits generally are a percentage of a certain type of qualifying expenditure the taxpayer has made.

The values of the taxpayer's exemptions and either itemized or standard deductions are subtracted to give **Montana Taxable Income**. The value of exemptions and maximum and minimum standard deductions are adjusted for inflation each year:

Tax Year 2008			Tax Year 2009	
Exemption Amount	\$2,140		\$2,110	
	Single and Separate Returns	Joint Returns	Single and Separate Returns	Joint Returns
Minimum Standard Deduction	\$1,780	\$3,560	\$1,750	\$3,500
Maximum Standard Deduction	\$4,010	\$8,020	\$3,950	\$7,900
Standard Deductions: 20% of Montana Adjusted Gross Income with Maximum and Minimum				

Tax liability is calculated from the rate table. The rate table is adjusted for inflation each year:

Tax Rate	For 2008 Applies to Income Over but Not Over		For 2009 Applies to Income Over but Not Over	
1.0%	\$0	\$2,600	\$0	\$2,600
2.0%	\$2,600	\$4,600	\$2,600	\$4,500
3.0%	\$4,600	\$7,000	\$4,500	\$6,900
4.0%	\$7,000	\$9,500	\$6,900	\$9,300
5.0%	\$9,500	\$12,200	\$9,300	\$12,000
6.0%	\$12,200	\$15,600	\$12,000	\$15,400
6.9%	\$15,600		\$15,400	

Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

The next six tables show information about individual line items on full year residents' income tax returns for 2008 and 2009. For each line item, the table shows the count of the number of returns with a value on that line and the sum of those values.

Montana Individual Income Tax Income Reported on Full-Year Residents' Returns 2008 and 2009				
	2008		2009	
	Count	Total	Count	Total
Income Items				
Wage and salary income	431,012	13,352,105,062	421,862	13,136,979,081
Taxable interest income	274,368	674,052,607	251,993	519,760,266
Exempt interest income*	26,829	181,764,183	26,496	178,610,589
Ordinary dividend income	136,766	592,113,015	125,833	462,423,006
Qualified dividend income *	114,243	432,759,688	n/a	n/a
Taxable refunds of state/local income taxes	103,259	101,843,624	100,555	113,741,795
Alimony received	839	12,216,684	832	12,834,607
Business income (Schedule C)	79,241	701,307,208	76,859	648,186,972
Capital gains income	114,334	1,337,809,696	94,436	912,040,530
Supplemental gains income	15,324	56,735,447	14,975	19,035,494
IRA distributions*	34,950	423,809,760	28,815	368,407,244
IRA distributions - Taxable amt	42,487	451,708,587	34,825	396,729,060
Pension and annuity income*	88,865	2,120,658,359	86,664	3,037,304,264
Pension and annuity income - Taxable amt	92,494	1,509,033,462	92,846	1,567,181,125
Rent, royalty, partnership, etc. income	95,986	1,735,147,210	95,190	1,508,400,268
Farm income	19,760	-210,130,661	19,326	-183,602,398
Unemployment compensation	31,654	102,993,388	33,542	174,819,293
Social Security Benefits*	104,002	1,509,624,382	105,371	1,646,131,586
Taxable social security benefits	63,579	527,626,179	63,158	540,620,199
Other income	<u>49,494</u>	<u>-214,412,339</u>	<u>42,531</u>	<u>-326,314,130</u>
Total income	537,508	20,730,149,169	528,318	19,502,835,168
* Indented items either are part of another line or include another line. They are not part of the total.				
Federal Adjustments to Income				
Educator Expense	11,075	255,694	11,230	2,641,663
Business expenses	588	1,624,564	582	1,447,975
Health Savings Account deduction	5,791	16,792,206	6,421	19,175,503
Moving expenses	3,126	4,722,743	2,587	3,547,466
One-half self-employment tax	61,780	74,863,322	59,832	70,605,043
Self-employed SEP, SIMPLE, and qual. plans	3,191	46,752,467	2,828	42,822,026
Self-employed health insurance deduction	21,303	102,338,278	20,351	98,936,900
Penalty on early withdrawal of savings	3,689	942,627	3,786	705,172
Alimony paid	1,186	13,387,308	1,162	13,843,756
IRA deduction	15,867	56,421,582	14,555	52,303,964
Student loan interest deduction	43,407	32,089,772	44,490	32,806,866
Tuition & fees deduction	14,602	34,238,086	6,872	15,216,928
Domestic production activities deduction	5,176	28,313,939	4,995	22,914,712
Federal write-ins	<u>352</u>	<u>2,699,970</u>	<u>317</u>	<u>1,767,132</u>
Total adjustments to income	142,736	417,743,804	136,576	378,735,106
Federal Adjusted Gross Income	537,530	20,312,405,365	528,328	19,124,100,062

Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

Montana Individual Income Tax Income Reported on Full-Year Residents' Returns 2008 and 2009

	2008		2009	
	Count	Total	Count	Total
Montana Additions to Federal Adjusted Gross Income				
Interest on other states' municipal bonds	17,321	94,380,505	17,681	92,212,666
Dividends not included in FAGI	155	221,776	441	702,870
Taxable federal refunds	90,034	122,652,586	83,066	122,976,647
Recoveries of amounts deducted in earlier years	833	468,721	285	973,921
Additions to federal taxable social security or railroad retirement	6,133	9,379,800	6,722	10,706,356
Allocation of compensation to spouse	611	9,563,306	482	7,202,972
Medical savings account nonqualified withdrawals	109	145,198	113	129,357
First-time homebuyer's account nonqualified withdrawals	8	35,384	14	29,691
Farm and ranch risk management account taxable distributions	1	200	1	697
Dependent care assistance credit adjustment	52	86,959	67	127,529
Smaller federal estate and trust taxable distributions	39	48,095	70	115,517
Federal net operating loss carryover	3,592	190,896,793	4,128	256,422,918
Federal taxes paid by your S. corporation	15	326,001	42	74,002
Title plant depreciation	0	0	2	3,548
Group health premiums reimbursed by Insure Montana credit	769	4,642,233	919	5,094,962
Other additions	<u>7,371</u>	<u>99,710,548</u>	<u>4,922</u>	<u>113,864,663</u>
Total Montana Additions	117,840	532,558,105	109,059	610,638,316

Montana Individual Income Tax Income Reported on Full-Year Residents' Returns 2008 and 2009

	2008		2009	
	Count	Total	Count	Total
Montana Subtractions from Federal Adjusted Gross Income				
Federal bonds exempt interest	28,534	51,862,384	23,963	37,421,242
Exempt tribal income	7,409	187,639,734	7,735	201,760,096
Exempt unemployment compensation	30,268	99,748,626	32,500	169,813,215
Exempt worker's comp benefits	77	400,335	204	1,006,241
Capital gains from small business investment companies	49	50,125	50	73,145
State tax refunds included in federal AGI	109,494	105,479,553	106,869	118,187,520
Recoveries of amounts deducted in earlier years	37	67,983	22	102,536
Exempt active duty military salary	4,142	131,691,515	4,297	142,046,880
Nonresident exempt military income	112	3,661,691	99	3,560,669
Exempt life insurance premiums reimbursement (National Guard)	126	447,340	41	441,796
Exempt pension income	42,005	134,023,768	41,280	132,876,584
Elderly interest exclusion	72,327	46,871,599	70,449	43,632,908
Exempt retirement disability income (under age 65)	91	369,876	155	656,765
Exempt tip income	11,142	31,562,631	13,348	38,921,676
Exempt income of child taxed to parent	145	251,424	44	99,782
Exempt health insurance premiums taxed to employee	283	1,127,728	160	644,902
Student loan repayments taxed to health care professional	102	294,799	134	370,976
Medical care savings account exempt deposits	7,524	16,967,593	7,425	17,483,938
First-time homebuyer exempt savings account deposits	196	538,398	254	710,124
Family education savings account exempt deposits	2,913	6,854,175	2,741	6,592,192
Farm and ranch risk management accounts exempt deposits	0	0	0	0
Subtraction to federal taxable social security/Tier 1 railroad retirement	31,901	104,252,490	32,847	113,084,380
Subtraction for federal taxable Tier II railroad retirement	3,054	35,527,084	3,025	36,473,121
Subtraction for spouse filing joint return: passive loss carryover	713	4,913,234	76	244,075
Subtraction for spouse filing joint return: capital loss adjustment	1,828	1,918,568	2,481	3,554,062
Allocation of compensation to spouse	611	9,564,024	502	7,418,488
Montana net operating loss carryover	3,397	177,036,342	3,867	242,163,391
40% capital gain exclusion on pre-1987 installment sales	626	2,813,975	250	1,124,567
Business expense of recycled material	72	179,028	115	136,675
Sales of land to beginning farmers	1	2,270	2	7,785
Larger federal estate and trust taxable distributions	153	311,890	110	264,183
Wage deduction reduced by federal targeted jobs credit	58	199,915	63	276,616
Certain gains recognized by liquidating corporation	13	399,697	5	29,686
Other subtractions	<u>4,373</u>	<u>108,699,708</u>	<u>4,154</u>	<u>126,816,297</u>
Total Montana Subtractions	246,009	1,265,729,502	243,960	1,447,996,513

Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

Montana Individual Income Tax Deductions Reported on Full-Year Residents' Returns 2008 and 2009

	2008		2009	
	Count	Total	Count	Total
Deductions				
Total medical expenses*	134,614	550,903,057	133,123	543,571,282
Deductible medical expenses	71,687	309,033,065	73,337	307,848,323
Medical insurance premiums not deducted elsewhere	102,280	328,606,170	103,054	345,055,072
Long-term care insurance premiums	13,640	26,552,393	13,264	26,195,277
Federal Income Tax				
Federal income tax withheld*	249,756	1,439,217,079	250,431	1,325,630,593
Federal income tax estimated payments*	55,434	761,008,071	50,339	573,787,410
Last year's federal income tax paid (e.g. with return)*	68,313	360,705,773	52,432	280,037,049
Federal income tax from previous years*	5,147	22,571,910	4,094	36,809,791
Federal economic stimulus rebate	256,154	543,735,650	n/a	n/a
Total federal income tax deduction (after \$5,000 cap)	262,564	977,041,035	280,813	1,007,165,809
State or Local Sales Tax**	n/a	n/a	577	621,978
Local income taxes	132	104,485	228	208,407
Real estate taxes	209,253	375,863,167	211,054	390,523,795
Personal property taxes	169,593	54,112,119	164,852	53,773,266
Other deductible taxes	22,848	8,494,096	26,256	8,631,187
Home mortgage interest	161,357	1,151,150,074	160,899	1,114,955,415
Unreported home mortgage interest	5,940	18,043,825	6,296	17,628,247
Unreported points	18,254	5,619,416	22,619	7,701,339
Qualified mortgage insurance premiums	11,577	12,656,499	17,371	21,264,234
Investment interest	9,061	49,397,642	8,395	31,368,971
Contributions by cash or check	171,569	434,698,282	169,596	424,565,892
Contributions other than cash or check	70,403	61,442,501	70,044	59,713,638
Carryover of contributions from previous years	2,567	34,852,686	2,750	26,683,941
Child and dependent care expenses	769	1,382,178	889	1,600,514
Casualty and theft losses	393	5,565,994	341	6,906,415
Business Expenses				
Unreimbursed employee business expenses*	57,683	187,311,818	56,602	169,613,660
Other business expenses*	142,412	113,984,827	142,920	102,707,081
Total business expenses*	160,914	301,296,645	161,528	272,320,741
Net deductible unreimbursed business expenses	56,879	213,814,844	57,450	191,103,224
Political contributions	11,307	1,062,633	7,052	643,598
All other miscellaneous deductions not subject to 2% floor	2,396	7,969,789	2,175	17,170,824
Gambling losses	<u>1,250</u>	<u>10,936,343</u>	<u>1,169</u>	<u>10,915,626</u>
Total itemized deductions	304,346	4,088,399,236	308,304	4,072,251,370
Unallowed itemized deductions (due to income over threshold)	<u>22,128</u>	<u>23,169,551</u>	<u>18,039</u>	<u>19,210,187</u>
Allowable itemized deductions	304,346	4,065,229,685	308,304	4,053,041,183
Standard deductions	<u>210,558</u>	<u>749,417,878</u>	<u>200,130</u>	<u>697,489,190</u>
Total deductions	531,358	4,814,647,563	523,618	4,750,530,373

* Indented items either are part of another line or include another line. They are not part of the total.

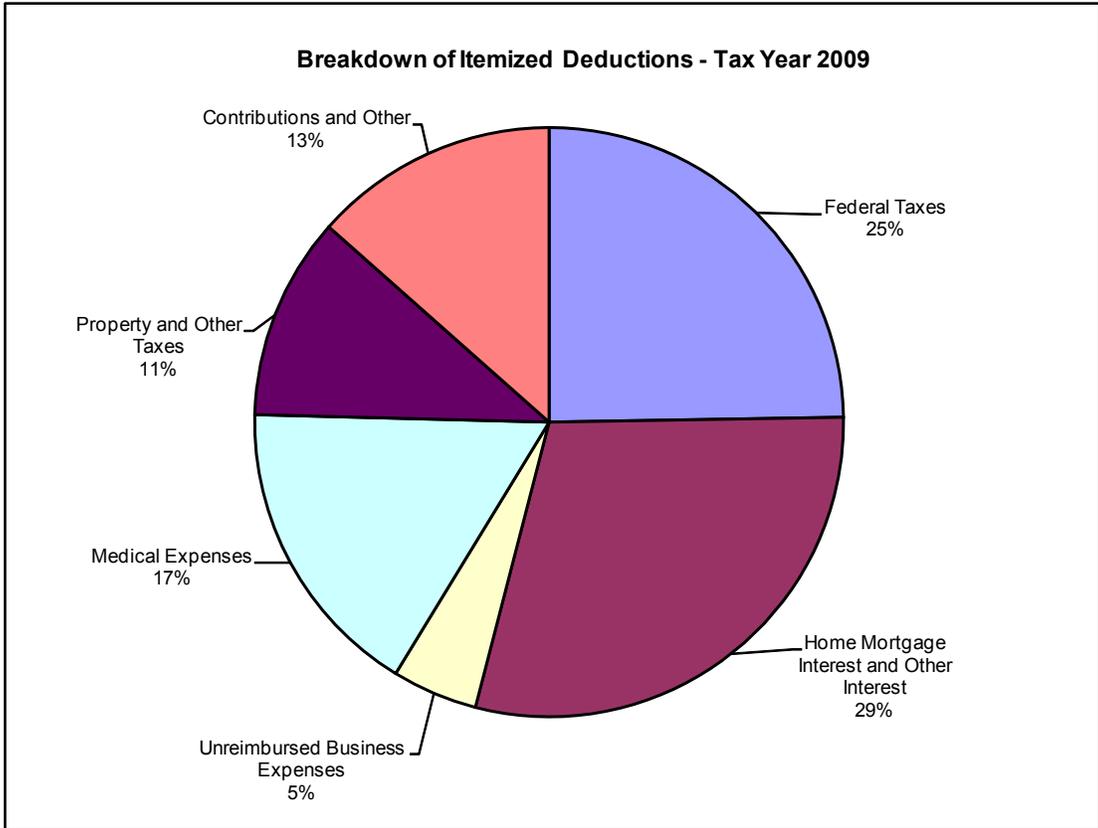
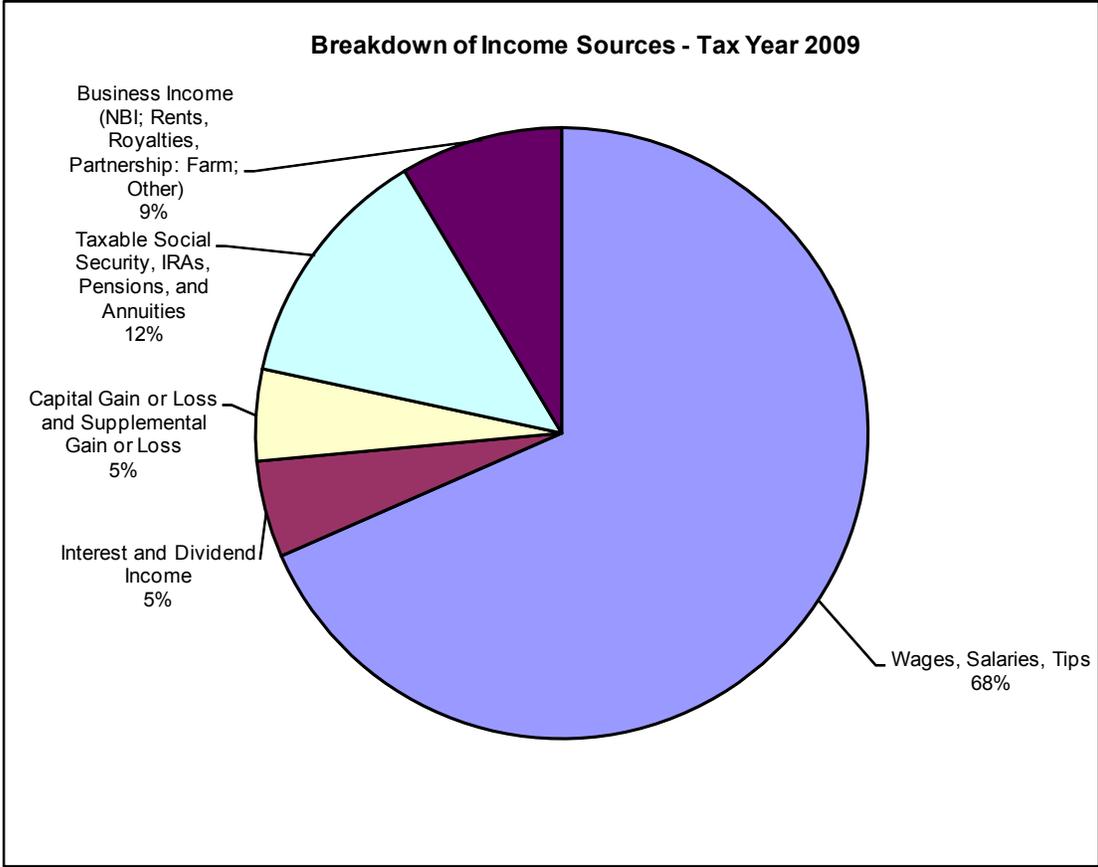
**For 2008, deductible sales tax was reported on the income tax line. It was given its own line for 2009.

Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

Montana Individual Income Tax Exemptions, Taxable Income, Tax, and Payments Reported on Full Year Residents' Returns 2008 and 2009				
	2008		2009	
	Count	Total	Count	Total
Exemptions *				
Self Exemption		n/a		488,987
Self 65 and Over Exemption		n/a		87,211
Self Blind Exemption		n/a		1,270
Total Taxpayer Exemptions	493,793	582,020	488,992	577,468
Spouse Exemption		n/a		77,278
Spouse 65 and Over Exemption		n/a		31,804
Spouse Blind Exemption		n/a		360
Total Spouse Exemptions	83,285	103,539	87,637	109,442
Dependent Exemptions	132,201	<u>233,053</u>	132,230	<u>234,714</u>
Total Exemptions	493,794	918,613	488,992	921,624
Value of Exemptions	538,660	\$2,065,590,060	529,582	\$2,033,750,930
Taxable Income				
Federal Adjusted Gross Income	537,530	\$20,312,405,365	528,328	\$19,124,100,062
+Montana Additions	117,840	\$532,558,105	109,059	\$610,638,316
-Montana Subtractions	246,009	\$1,265,729,502	243,960	\$1,447,996,513
-Deductions	531,358	\$4,814,647,563	523,618	\$4,750,530,373
-Value of Exemptions	<u>538,660</u>	<u>\$2,065,590,060</u>	<u>529,582</u>	<u>\$2,033,750,930</u>
Montana Taxable Income	444,818	\$13,848,799,301	430,879	\$12,823,448,468
Tax from Tax Table	444,077	\$767,801,378	430,142	\$705,718,484
Capital Gains Credit	51,631	\$26,151,925	30,696	\$17,974,296
Tax before Credits & Adjustments	440,443	\$741,649,453	427,615	\$687,744,188
Tax on Lump Sum Distributions	49	\$17,166	39	\$6,437
Recapture of Credits Claimed Previously	21	<u>\$22,472</u>	25	<u>\$38,872</u>
Total Tax		\$741,689,091		\$687,789,497
Payments				
Montana income tax withheld from wages	423,083	\$602,973,245	413,663	\$594,092,298
Tax withheld from mineral royalties	2,474	\$6,173,658	2,656	\$2,676,680
Tax withheld by pass-through entities	n/a	n/a	100	\$98,744
Estimated tax payments	50,898	\$202,271,498	47,153	\$156,234,826
Extension payments	4,421	<u>\$20,857,241</u>	3,707	<u>\$25,498,836</u>
Total Payments		\$832,275,642		\$778,601,384
<p>* Taxpayers claim exemptions for themselves and their spouses by checking boxes on the return. The counts for exemptions show the number of returns where the taxpayer claimed at least one exemption for themselves, their spouse, or dependents. The totals column shows the number and type of exemptions claimed. For the taxpayer and spouse, the totals column shows the numbers of basic exemptions and extra exemptions for being 65 or over or blind. For 2008, only the total number of taxpayer and spouse exemptions was recorded. For dependent exemptions, the count is the number of returns claiming at least one dependent, and the total is the number of dependents claimed.</p>				

Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

Montana Individual Income Tax Credits Reported on Full-Year Residents' Returns 2008 and 2009				
	2008		2009	
	Count	Total	Count	Total
Credits				
Non-Refundable and No Carryover				
Other states' income tax credit	10,735	20,931,634	9,765	16,975,208
College contribution tax credit	2,767	225,228	2,820	237,180
Qualified endowment tax credit	617	1,919,025	579	1,746,260
Energy conservation tax credit	23,656	7,853,727	28,594	9,998,955
Alternative fuel tax credit	45	27,402	55	38,175
Rural physician's tax credit	35	160,294	20	90,312
Insurance for uninsured Montanans credit	493	413,966	377	294,402
Elderly care tax credit	46	48,026	42	45,059
Recycling tax credit	77	527,908	85	439,254
Oil seed crushing/biodiesel facility credit	<10	4,047	0	0
Biodiesel blending/storage tank credit	<10	1,090	<10	2,630
Non-Refundable but with Carryover				
Contractor's gross receipts tax credit	463	1,738,387	510	2,676,113
Geothermal systems tax credit	156	215,157	302	525,153
Alternative energy systems credit	1,804	997,615	2,321	1,302,796
Alternative energy production tax credit	<10	8,315	15	33,086
Dependent care assistance credit	<10	24,116	<10	7,769
Historic property preservation tax credit	18	60,116	23	134,543
Infrastructure user fee credit	16	30,372	12	27,699
Empowerment zone credit	0	0	0	0
Research activities tax credit	12	391,790	17	345,813
Mineral exploration tax credit	<10	44,530	<10	7,749
Film production employment tax credit	0	0	0	0
Adoption credit	205	186,069	194	165,300
Total Non-Refundable Credits	39,108	35,808,814	43,357	35,093,456
Refundable Credits				
Elderly homeowner/renter tax credit*	16,698	8,252,383	17,053	8,465,090
Film production employment tax credit	0	0	0	0
Film qualified expenditure tax credit	<10	29,230	<10	19,047
Insure Montana small business health insurance credit	792	2,380,374	911	2,513,344
Emergency lodging credit	<10	396	0	0
Total Refundable Credits	13,806	8,901,758	14,497	9,311,534
Total Credits	69,252	66,387,531	75,430	63,883,305
* Credits claimed on tax returns. See the Property Tax section for credits claimed with no income tax return.				



Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

The following tables show Montana adjusted gross income, deductions, taxable income and tax liability by decile group. Each decile group is 10% of the population of returns, sorted by adjusted gross income. Group 1 is the 10% with the lowest incomes, while group 10 is the 10% with the highest incomes. In these tables, a married couple who files separate returns on the same form are counted as two returns, and their income and tax is counted separately.

Deciles of Montana Adjusted Gross Income Full Year Residents 2008 and 2009

Decile Group	2008				2009			
	Returns	Income Range	Montana Adjusted Gross Income		Returns	Income Range	Montana Adjusted Gross Income	
			\$ million	% of total			\$ million	% of total
1	53,870	less than \$3,515	-\$459.1	-2%	52,962	less than \$3,147	-\$582.2	-3%
2	53,870	\$3,515 to \$8,227	\$316.0	2%	52,963	\$3,147 to \$7,822	\$290.9	2%
3	53,870	\$8,228 to \$13,260	\$577.3	3%	52,962	\$7,823 to \$12,724	\$542.3	3%
4	53,870	\$13,261 to \$18,507	\$854.5	4%	52,963	\$12,725 to \$17,963	\$810.7	4%
5	53,870	\$18,508 to \$24,164	\$1,146.3	6%	52,963	\$17,964 to \$23,599	\$1,098.0	6%
6	53,870	\$24,165 to \$31,036	\$1,479.8	8%	52,962	\$23,600 to \$30,408	\$1,422.0	8%
7	53,870	\$31,037 to \$39,139	\$1,882.6	10%	52,963	\$30,409 to \$38,529	\$1,818.9	10%
8	53,870	\$39,140 to \$49,821	\$2,378.5	12%	52,962	\$38,530 to \$49,303	\$2,308.6	13%
9	53,870	\$49,822 to \$69,389	\$3,130.9	16%	52,963	\$49,304 to \$68,155	\$3,042.3	17%
10	53,870	more than \$69,389	\$8,272.2	42%	52,963	more than \$68,155	\$7,535.3	41%
All	538,700		\$19,579.2		529,626		\$18,286.7	

Deductions by Decile Group Full Year Residents 2008 and 2009

Decile Group	% Returns Itemize	2008				2009				
		Itemized Deductions		Standard Deductions		Itemized Deductions		Standard Deductions		
		\$ million	average	\$ million	average	\$ million	average	\$ million	average	
1	28%	\$135.1	\$8,837	\$84.0	\$2,177	34%	\$157.1	\$8,831	\$76.6	\$2,177
2	26%	\$85.8	\$6,026	\$81.6	\$2,060	28%	\$93.4	\$6,332	\$77.7	\$2,032
3	37%	\$142.0	\$7,064	\$83.9	\$2,483	38%	\$138.5	\$6,880	\$79.0	\$2,406
4	43%	\$177.4	\$7,694	\$100.6	\$3,263	44%	\$183.0	\$7,863	\$94.2	\$3,172
5	46%	\$198.1	\$8,030	\$117.9	\$4,037	47%	\$208.8	\$8,345	\$110.5	\$3,954
6	56%	\$264.3	\$8,832	\$105.5	\$4,405	57%	\$267.0	\$8,884	\$99.6	\$4,348
7	71%	\$400.5	\$10,475	\$79.7	\$5,099	72%	\$403.6	\$10,525	\$73.7	\$5,041
8	84%	\$568.1	\$12,541	\$51.8	\$6,044	85%	\$561.3	\$12,476	\$48.2	\$6,049
9	91%	\$749.8	\$15,355	\$32.6	\$6,478	92%	\$737.2	\$15,175	\$27.9	\$6,372
10	97%	\$1,344.2	\$25,840	\$11.8	\$6,402	97%	\$1,303.3	\$25,373	\$10.1	\$6,338
All	58%	\$4,065.2	\$11,607	\$749.4	\$3,301	59%	\$4,053.0	\$11,598	\$697.5	\$3,239

Income, Deductions, Credits, and Tax from 2008 and 2009 Returns

Deductions as % of Montana Adjusted Gross Income Full Year Residents 2008 and 2009

Decile Group	2008			2009		
	Itemized Deductions	Standard Deductions	All	Itemized Deductions	Standard Deductions	All
1	-37%	-93%	-48%	-33%	-70%	-40%
2	99%	36%	53%	112%	37%	59%
3	65%	23%	39%	67%	24%	40%
4	48%	21%	33%	51%	21%	34%
5	38%	19%	28%	40%	19%	29%
6	32%	16%	25%	33%	16%	26%
7	30%	15%	26%	31%	15%	26%
8	28%	14%	26%	29%	14%	26%
9	26%	11%	25%	26%	11%	25%
10	17%	6%	16%	18%	6%	17%
All	26%	20%	25%	27%	21%	26%

Taxable Income and Tax Full Year Residents 2008 and 2009

Decile Group	2008						2009					
	Taxable Income			Tax Liability			Taxable Income			Tax Liability		
	\$ million	Average	% of Total	\$ million	Average	% of Total	\$ million	Average	% of Total	\$ million	Average	% of Total
1	\$0.4	\$7	0%	\$0.0	\$0	0%	\$0.2	\$3	0%	\$0.0	\$0	0%
2	\$72.2	\$1,340	1%	\$0.8	\$16	0%	\$59.6	\$1,125	0%	\$0.7	\$13	0%
3	\$231.3	\$4,293	2%	\$4.3	\$79	1%	\$210.3	\$3,971	2%	\$3.8	\$72	1%
4	\$421.6	\$7,827	3%	\$11.0	\$204	1%	\$387.2	\$7,310	3%	\$9.9	\$187	1%
5	\$656.4	\$12,184	5%	\$22.4	\$416	3%	\$610.8	\$11,533	5%	\$20.6	\$388	3%
6	\$929.6	\$17,256	7%	\$39.0	\$723	5%	\$877.4	\$16,567	7%	\$36.4	\$687	5%
7	\$1,206.9	\$22,404	9%	\$57.3	\$1,063	7%	\$1,151.5	\$21,742	9%	\$54.4	\$1,027	8%
8	\$1,552.1	\$28,811	11%	\$80.7	\$1,498	11%	\$1,495.6	\$28,239	12%	\$77.6	\$1,465	11%
9	\$2,119.9	\$39,352	15%	\$119.6	\$2,221	16%	\$2,057.0	\$38,839	16%	\$116.1	\$2,192	16%
10	\$6,658.5	\$123,602	48%	\$432.7	\$8,032	56%	\$5,973.9	\$112,793	47%	\$386.3	\$7,293	55%
All	\$13,848.8	\$25,708		\$767.8	\$1,425		\$12,823.4	\$24,212		\$705.7	\$1,332	

Tax As % of Adjusted Gross Income Full Year Residents 2008 and 2009

Decile Group	2008			2009		
	Montana Adjusted Gross Income	Tax Liability	Tax / Income	Montana Adjusted Gross Income	Tax Liability	Tax / Income
	\$ million	\$ million	%	\$ million	\$ million	%
1	-\$459.1	\$0.0	0.0%	-\$582.2	\$0.0	0.0%
2	\$316.0	\$0.8	0.3%	\$290.9	\$0.7	0.2%
3	\$577.3	\$4.3	0.7%	\$542.3	\$3.8	0.7%
4	\$854.5	\$11.0	1.3%	\$810.7	\$9.9	1.2%
5	\$1,146.3	\$22.4	2.0%	\$1,098.0	\$20.6	1.9%
6	\$1,479.8	\$39.0	2.6%	\$1,422.0	\$36.4	2.6%
7	\$1,882.6	\$57.3	3.0%	\$1,818.9	\$54.4	3.0%
8	\$2,378.5	\$80.7	3.4%	\$2,308.6	\$77.6	3.4%
9	\$3,130.9	\$119.6	3.8%	\$3,042.3	\$116.1	3.8%
10	\$8,272.2	\$432.7	5.2%	\$7,535.3	\$386.3	5.1%
All	\$19,579.2	\$767.8	3.9%	\$18,286.7	\$705.7	3.9%

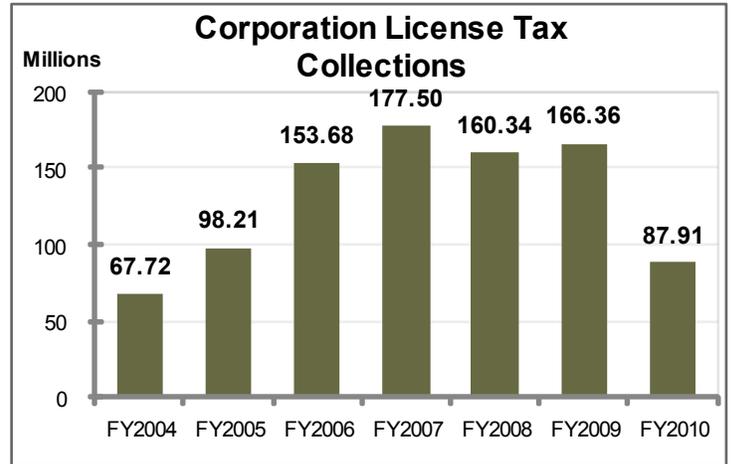
Overview of Corporate License Tax

Overview of Corporate License Tax

Montana's corporate license tax is a franchise tax levied on C corporations for the "privilege of carrying on business in this state" (15-31-101(3), MCA). A corporation includes

an association, joint-stock company, common-law trust or business trust that does business in an organized capacity, all other corporations whether created, organized, or existing under and pursuant to the laws, agreements, or declarations of trust of any state, country or the United States, and any limited liability company, limited liability partnership, partnership or other entity that is treated as an association for federal income tax purposes and that is not a disregarded entity (15-31-101(1), MCA).

Every bank organized under the laws of Montana or another state or under the United States and every savings and loan organized under state law or United States law is also subject to corporate license tax (15-31-101(4), MCA).



The table to the left and graph above show total corporate license tax collections for fiscal years 2004 through 2010. As a rule, corporate income tax collections in Montana follow the general national economy. Total collections in FY 2004 (which started on July 1, 2003) were \$67.7 million, increasing to \$177.5 million in FY 2007 and declining to \$87.9 million in FY 2010. Corporate license taxes are deposited in the state general fund.

The table below provides a breakdown of revenues for the last five years by how they are collected and shows refunds.

As can be seen from the table, estimated payments is the largest source of corporate tax collections followed by payments with returns. Average revenue over the five years was \$39.556 million for payments with returns and \$112.215 million for estimated payments. Audit collections have ranged from \$10.8 million to \$31.0 million and averaged \$20.2 million per year over the five years.

Corporation License Tax Collections	
FY 2004	\$67,722,940
FY 2005	\$98,213,717
FY 2006	\$153,675,069
FY 2007	\$177,503,707
FY 2008	\$160,341,787
FY 2009	\$166,357,514
FY 2010	\$87,906,411

Corporation License Tax Collections, Refunds and Fees					
	Payments with Returns	Estimated Payments	Audit Collections ¹	Refunds	Total Collections
FY 2006	44,163,925	109,666,297	10,830,003	(10,985,156)	\$153,675,069
FY 2007	31,625,075	141,658,487	26,814,040	(22,593,895)	\$177,503,707
FY 2008	39,473,130	127,433,439	16,874,522	(23,439,304)	\$160,341,787
FY 2009	45,608,755	109,585,667	31,041,454	(19,881,362)	\$166,354,514
FY 2010	36,909,143	72,732,614	15,380,337	(37,121,182)	\$87,900,911
Average	39,556,005	112,215,301	20,188,071	(22,804,180)	149,155,198

¹ Includes penalties and interest as well as taxes collected

Overview of Corporate License Tax

Refunds averaged \$22.8 million per year, but were as low as \$11.0 million in FY 2006, and as high as \$37.1 million in FY 2010. Total collections averaged \$149.155 million per year, but ranged between \$87.9 million in FY 2010 up to \$177.5 million in FY 2007.

Organizations exempt from the tax include corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, and whose income does not benefit any stockholder or individual. Other entities exempt from corporate license tax include labor, agricultural or horticultural organizations; civic organizations operated exclusively for the promotion of social welfare; clubs or corporations organized and operated exclusively for pleasure; recreation or other nonprofit purposes and who do not have any income that benefits any private stockholder or member; and similar non-profit organizations. Unrelated business taxable income, as defined by federal law, of exempt organizations which creates more than \$100 of federal tax liability is taxable as corporate income in the same manner as other taxable corporate income. In order to receive treatment as exempt from state corporation taxes, the corporation must prove it is in compliance with all statutory conditions (15-31-102, MCA and ARM 42.23.103).

Research and development (R&D) firms organized to engage in business for the first time in Montana are not subject to the corporate license tax for the first five years of operation. In order to receive this tax treatment the firm must make an application to the Department of Revenue and be approved as meeting legislative requirements (15-31-103, MCA).

Only C corporations pay corporate license taxes. Corporations that elect to file as a subchapter S corporation for federal tax purposes are also required to file as a subchapter S corporation for Montana corporate license tax purposes. Despite the filing requirement, subchapter S corporations do not pay Montana corporate license taxes. Instead the owners or shareholders of the S corporation are subject to income tax on income channeled through the S corporation to the owner or shareholder. Then the owner/shareholder reports any taxable income on their individual income tax form. S corporations are discussed in the section on pass-through entities following this section.

The table on the following page provides a distribution by Montana tax liability of the 14,173 corporate returns with a Montana tax liability filed in fiscal year 2010. Altogether the top 100 returns constituted nearly 80% of total tax liability for the group and the top 500 returns accounted for over 90% of total Montana tax liability for the group. The other 13,675 returns accounted for only 8.0% of the total Montana tax liability.

The starting point for calculating Montana corporation license tax is the corporation's federal taxable income. In order to determine net income taxable by Montana, certain adjustments to federal taxable income must be made. For example, municipal bond interest is taxable and must be added to income. Montana also allows certain reductions to income, such as a portion of the cost of energy conservation investments made in a building used for the corporation's business. Then after additions and reductions, income is apportioned to Montana to produce Montana taxable income.

If the corporation conducts business that is taxable only in Montana, then all of the net income from that business is Montana taxable income. The tax is levied at a rate of 6.75% on net income earned in Montana.

Multi-state corporations conducting business that is taxable both in and outside the state are required to apportion income to Montana based on an equally weighted, three-factor apportionment formula. Sales, property and payroll comprise the three factors used in the apportionment formula. The payroll factor is the ratio of payroll paid in compensation attributable to the production of business income during the tax period in Montana to all payroll paid. Similarly, the property factor is based on the ratio of Montana property to all property and the sales factor is based on the ratio of Montana sales to all

Returns Filed in Tax Year 2010

Regular or C Corporations	14,173
S Corporations	25,603
Total Corporations	39,776
Corporations Paying \$50 Minimum Tax *	9,578
Corporations Paying More Than \$50 Minimum Tax	4,595
Total Regular Corporations	14,173

* Includes corporations filing a tax return, but claiming zero taxable income

Overview of Corporate License Tax

Corporate Returns Filed for Tax Year 2010 Distribution of Montana Tax Liability				
<u>Regular Corporation Returns</u>	<u>Number</u>	<u>Tax Liability</u>	<u>Percent of Total Liability</u>	<u>Cumulative Percent of Total Liability</u>
Top 100 returns	100	\$91,509,931	77%	77%
Second 100 returns	100	8,794,798	7%	84%
Third 100 returns	100	4,428,006	4%	88%
Fourth 100 returns	100	2,694,906	2%	90%
Fifth 100 returns	100	1,741,511	1%	92%
All other returns	13,673	9,792,779	8%	100%
Total	14,173	\$118,961,931	100%	n/a

sales. The tax is normally levied at a rate of 6.75% on net income apportioned to Montana, with exceptions explained below.

Following is an example showing how a multi-state corporation doing business in Montana would calculate its Montana source income. The corporation, Company A, has \$1 million in payroll in Montana out of total payroll of \$10 million; \$2 million of property in Montana out of total property of \$125 million; and sales in Montana of \$4 million out of total sales of \$100 million during the tax year.

Example of apportionment factor calculation for a multi-state corporation			
Company A has:			
Payroll in Montana	Total Payroll	Payroll Factor	
\$1,000,000	\$10,000,000	=	0.1
Property in Montana	Total Property	Property Factor	
\$2,000,000	\$125,000,000	=	0.016
Sales in Montana	Total Sales	Sales Factor	
\$4,000,000	\$100,000,000	=	0.04
Equally weighted factor	Add factors together		0.156
	then divide by 3		0.052
	which equals		0.052
So the apportionment factor is:			0.052

These facts result in an apportionment factor of 0.052. If this corporation had total taxable income of \$10,000,000, then its Montana taxable income is \$520,000 (\$10 million times 0.052), and its state income tax is \$35,100 (before credits).

Montana is a worldwide, combined unitary state. A business is unitary when the operations of that business within the state depend on or contribute to the operations of that business outside the state. However, in Montana, corporations can elect to have only their United States income included in the apportionment process. Corporations taking this election, called a "water's edge" election, pay the tax at a rate of 7% instead of 6.75%. Multinational unitary corporations wishing to file under the water's edge method are required to file a written election within the first 90 days of the tax period for which the election is to become effective. The Department of Revenue must approve the election before the corporation uses it and the election is binding for three consecutive taxable periods.

Corporations whose only activity in Montana consists of making sales, and who do not own or rent real estate or tangible personal property, and whose annual gross volume of sales made in Montana does not exceed \$100,000 may elect to pay an alternative tax equal to 1/2 of 1% of gross sales.

There is a minimum tax of \$50 for any corporation doing business in the state. The table on returns filed in Fiscal Year 2010 earlier in this section shows that for those returns filed in FY 2010 by corporations, the minimum tax was paid on 9,578 returns, or almost 68%. If the corpora-

Overview of Corporate License Tax

tion has no property, sales, or payroll in the state during the tax period, it is exempt from the minimum tax.

In Montana, net operating losses (NOL) of the corporation may be carried back for a period of three years and used to reduce prior year income, and may be carried forward for a period of seven years to reduce income in those future years. Until recently, federal tax rules allowed NOLs to be carried back two years and then forward for up to 20 years (corporations can also voluntarily elect to just carry forward losses for up to 20 years). However, in November 2009, H.R. 3548, the "Worker, Homeownership, and Business Assistance Act of 2009", became law. This act increases the allowable carryback period for applicable net operating losses at the federal level for most corporations from 2 years to 3, 4, or 5 years. An applicable NOL means the taxpayer's NOL for any tax year ending after Dec. 31, 2007, and beginning before Jan. 1, 2010.

The table below provides a comparison of Montana treatment of net operating loss deductions versus other states in the region. Like Montana, Utah provides a three year carryback of net operating losses, but has a limit of \$1 million. Utah allows losses to be carried forward up to 15 years versus 7 years for Montana. Idaho allows losses to be carried back against income for up to 2 years, but limits carryback losses to \$100,000; Idaho allows carryforward of losses for up to 20 years. Arizona, Colorado, North Dakota and Oregon allow carry-

forward of losses for 5 years, 20 years, 20 years and 15 years, respectively, and do not allow carryback of loss deductions.

The table on the next page provides a comparison of all states with a corporate income tax and what they allow in terms of carrying net operating losses backward and forward. All states with a corporate income tax allow some form of carryforward of losses, from five to twenty years, but many do not allow carryback of net operating losses.

Comparison with Other States in Region with a Corporate Income Tax Net Operating Loss Deductions	
State	Carryback/Carryforward periods
Arizona	0 back, 5 forward
Colorado	0 back, 20 forward
Idaho	2 back (\$100,000 limit), 20 forward, or 0 back, 20 forward
Montana	3 back, 7 forward
North Dakota	0 back, 20 forward
Oregon	0 back, 15 forward
Utah	3 back (limited to \$1 million), 15 forward
Nevada, Washington and Wyoming do not have a corporate income tax.	

Overview of Corporate License Tax

Thirty one states do not allow carryback of net operating losses, but do allow carryforward of losses, from 5 years up to 20 years. Twelve states allow the same carryforward and carryback periods as federal tax law has his-

torically allowed (2 back and 20 forward). Three states - Montana, Utah and Louisiana – allow corporations with net operating losses to carry back these losses against the three prior years of income.

States with Corporate Taxes							
Allowed Carrybacks and Carryforward Periods for Net Operating Losses							
		Allowed years of carryforward					
		5 years forward	7 years forward	10 years forward	12 years forward	15 years forward	20 years forward
Allowed years of carryback	0 years back	Arizona Arkansas Massachusetts Nebraska New Mexico Rhode Island Texas	New Jersey	Kansas Michigan New Hampshire ^{3/} Vermont	Illinois	Alabama Minnesota North Carolina Oregon Tennessee Wisconsin	California Colorado Connecticut District of Columbia Florida Iowa Kentucky Maine North Dakota Ohio Pennsylvania ^{5/} South Carolina
	2 years back					Alaska Delaware ^{1/} Georgia Hawaii Idaho ^{2/} Indiana Maryland Mississippi Missouri New York ^{4/} Virginia West Virginia ^{7/}	
	3 years back		Montana			Louisiana Utah ^{6/}	

Source: 2010 State Tax Handbook, CCH, 2009.

^{1/} Delaware has a \$30,000 limits on carrybacks.

^{2/} Idaho has a \$100,000 limit on carrybacks.

^{3/} New Hampshire limits carryforward of losses to \$1 million.

^{4/} New York has a limit of the first \$10,000 of loss on carrybacks.

^{5/} Pennsylvania has a limit of \$3 million or 15% of taxable income for tax year 2009, and \$3 million or 20% of taxable income for tax year 2010 on carryforward.

^{6/} Utah has a \$1 million limit on carrybacks.

^{7/} West Virginia limits carrybacks to \$300,000.

Overview of Corporate License Tax

Credits

As with individual income tax, corporations with expenditures that qualify can claim tax credits. The following

table shows what credits have been claimed in the last two fiscal years and the number of corporations claiming those credits.

Montana Corporation Tax Credits				
Credit	--- Fiscal Year 2009 ---		--- Fiscal Year 2010 ---	
	Number of Credits	Total Credit Amounts	Number of Credits	Total Credit Amounts
Contractors Gross Receipts Tax Credit	91	1,692,954	72	487,413
Charitable Endowment Credit	18	54,516	29	103,189
Montana Recycling Credit	*	70,936	*	25,937
Credit for Increasing Research Activities	22	588,068	12	82,965
Credit for Contribution to MT University or Private College	31	6,714	19	3,636
Montana Capital Company Credit	0	0	0	0
Health Insurance for Uninsured Montanans Credit	86	65,632	61	43,400
Credit for Alternative Fuel Motor Vehicle Conversion	0	0	*	6,000
Alternative Energy Production Credit	*	15,094	*	50
Dependent Care Assistance Credit	0	0	0	0
New/Expanded Industry Credit	0	0	0	0
Historical Building Credit	0	0	0	0
Infrastructure Users Fee Credit	*	541,522	*	431,692
Mineral Exploration Incentive Credit	*	1,361	*	25
Interest Differential Credit	0	0	0	0
Film Production Credit	*	16,583	0	0
Biodiesel Blending and Storage Credit	0	0	0	0
Oilseed Crushing and Biodiesel Production Credit	0	0	0	0
Geothermal System Credit	0	0	0	0
Insure Montana Credit	164	1,009,331	155	880,874
Empowerment Zone Credit	0	0	0	0
Total Credits	427	4,062,711	358	2,065,181

Some of the above credits are claimed on returns that have not been audited yet. The amount of credit claimed may change once these returns are audited. In addition, some of the above numbers represent a carryback of some credits claimed on amended returns received during the fiscal year.

* Indicates that credits were claimed on fewer than 10 returns.

Estimated Payments

Companies with a tax liability of \$5,000 or more have to make quarterly estimated payments. Tax returns for taxpayers using a calendar year as their fiscal year are due May 15th. Tax returns for taxpayers using another period as their fiscal year are due the 15th day of the fifth month after close of the taxable year. Taxpayers must use the same tax period they used on the federal tax return. Automatic extensions are allowed for up to six months following the prescribed filing date.

Penalties and Interest

Corporations who do not pay a tax when due may be assessed a late payment penalty of 1.2% per month on the unpaid tax, up to a maximum penalty of 12% of the tax due. Interest on unpaid tax accrues at a rate of 12% per year, or at 1% per month or fraction of a month on

Comparison of State Corporate Tax Rates

Maximum Corporate Tax Rate By State From Highest to Lowest - Tax Year 2010

Rank	State	Maximum Tax Rate
1	Iowa *	12.00%
2	Pennsylvania	9.99%
3	District of Columbia	9.975%
4	Minnesota	9.80%
5	Alaska *	9.40%
6	New Jersey	9.00%
6	Rhode Island	9.00%
8	Maine *	8.93%
9	California	8.84%
10	Massachusetts	8.75%
11	Delaware	8.70%
12	Indiana	8.50%
12	New Hampshire	8.50%
12	West Virginia	8.50%
12	Vermont *	8.50%
16	Maryland	8.25%
17	Louisiana *	8.00%
18	Wisconsin	7.90%
18	Oregon	7.90%
20	Nebraska *	7.81%
21	Idaho	7.60%
21	New Mexico *	7.60%
23	Connecticut	7.50%
24	Illinois	7.30%
25	New York	7.10%
26	Arizona	6.968%
27	North Carolina	6.90%
28	Montana	6.75%
29	Alabama	6.50%
29	Arkansas *	6.50%
29	Tennessee	6.50%
32	North Dakota *	6.40%
32	Hawaii *	6.40%
34	Missouri	6.25%
35	Kentucky *	6.00%
35	Georgia	6.00%
35	Oklahoma	6.00%
35	Virginia	6.00%
39	Florida	5.50%
40	Mississippi *	5.00%
40	South Carolina	5.00%
40	Utah	5.00%
43	Michigan	4.95%
44	Colorado	4.63%
45	Kansas	4.00%

As of Jan. 1, 2010. Federation of Tax Administrators

the unpaid tax.

Comparison of Corporate Tax Rate with Other States

Forty-four states and the District of Columbia have a tax on corporate income. The table to the left uses data from the Federation of Tax Administrators (as of January 1, 2010) to show the maximum rates for states that have a corporate tax. These go from 12% down to 4%.

A number of states have a graduated income tax which is indicated by an asterisk next to the state.

Nevada, Washington and Wyoming do not have state income corporation taxes. Texas imposes a franchise tax based on gross revenues and South Dakota has a tax on financial institutions only. Ohio has adopted a commercial activity tax which is a tax on gross receipts.

The table below provides a comparison of Montana's tax rate with the maximum tax rate for other states in the region that have a corporate income tax. As noted before, Nevada, Washington and Wyoming do not have corporate income taxes.

Maximum Corporate Tax Rate Regional Ranking - Tax Year		
Rank	State	Maximum Tax Rate
1	Oregon	7.90%
2	Idaho	7.60%
3	Arizona	6.97%
4	Montana	6.75%
5	North Dakota *	6.40%
6	Utah	5.00%
7	Nevada	0.00%
8	Washington	0.00%
9	Wyoming	0.00%

Business Structure and Taxation

States offer businesses a variety of options for legal organization. Different business forms give the owners different levels of liability for the business' actions and debts, different structures for making business decisions, and different levels of access to capital markets.

For tax purposes, each of these business structures falls into one of three categories: sole proprietor businesses, pass-through entities, and C corporations.

Income from a sole-proprietor business is reported on the owner's tax return and is taxed as the owner's income. A pass-through entity files an informational return showing its income and how the income is divided between the owners. The owners are taxed on their shares of the business' income, whether or not the income is distributed to them, but the business is not taxed. Pass-through entities can be either S corporations or partnerships, and somewhat different accounting procedures apply to how net income can be distributed between owners. A C corporation files a return and is taxed on its net income. The owners are taxed on dividends the business pays them.

In many cases, a firm's legal business structure determines its tax treatment, but some firms can choose between two or more options for tax treatment.

Pass-through entities include partnerships; S corporations; limited liability companies (LLCs); real estate investment trusts (REITS); regulated investment companies (RICs), better known as mutual funds; and others. Partnerships are an old and familiar business entity to many, but S corporations are less so. The S corporation rules were enacted in 1958 and permit a corporation and its shareholders to elect to be taxed at one level. However, S corporation status has limitations relative to C corporations. S corporations can have no more than 100 shareholders, although family members are treated as one shareholder. Only one class of stock is allowed, and ownership is limited to U.S. taxpayers or entities.

The most common type of pass-through entity today is the limited liability company, or LLC. The first LLC statute was enacted in Wyoming in 1977, and now all states and the District of Columbia have LLC statutes. For federal tax purposes, LLCs are generally treated as partnerships, although LLCs can elect to be treated as S corporations. A single member LLC can elect to be treated as a sole proprietorship if the single member is an individual; if the single member is a corporation,

then the LLC is treated as a division of a corporation. In both cases, the LLC's income is reported on the owner's return and the LLC does not file a separate return. In Montana an entity generally has the same status as it has for federal tax purposes. For example, if a business filed as an S corporation at the federal level, it must file as an S corporation at the state level.

Partnerships and S corporations are "traditional" pass-through entities. Their income, deductions, and credits pass-through to the owners and the owners report the items on their tax returns. Although they are traditional corporations, REITs and RICs are effectively pass-through entities because they are allowed a deduction for dividends paid to shareholders. Therefore, usually the REIT or RIC pays no tax and the shareholders are only taxed on their REIT or RIC income. A limited liability company has no independent tax status. Instead it is taxed as either an S corporation, or a partnership or a C corporation; if it has only one owner, the LLC's existence is disregarded for most tax purposes.

The following table shows characteristics of businesses falling into each of the four business tax categories.

Overview of Pass-Through Entities

Business Structure and Taxation				
	Individual	Pass-Through Entity (S - Corporation or Partnership)	C - Corporation	Disregarded Entity
Legal Business Organization	Informal	Partnership, Limited Liability Company (LLC), Corporation, Limited Partnership, etc.	Corporation	Single Member LLC, etc.
May be Owned By	One Individual or Married Couple	Individuals or Other Business Entities	Individuals or Other Business Entities	Individuals or Other Business Entities
Business Income and Owner's Income	The business' net income is all attributed to the owner.	The business calculates its net income, and this income is attributed to the owners.	The business calculates its net income. Owners' income is dividends received.	The business' net income is all attributed to the owner.
Distribution of Income to Owners	The business' net income is the owner's income from the business.	Distributions to owners need not equal business' current net income.	Business pays dividends to shareholders. Dividends need not equal business' current net income.	Distribution to owner need not equal business's current net income.
Taxation	Owner reports income from business as part of income subject to individual income tax	No tax at the entity level. Owners responsible for tax on income attributed to them.	Business' net income subject to corporation license tax. Owners taxed on dividends.	Entity is ignored. Business' income is taxed as owner's income.
Reporting	The business' receipts and costs are reported on Schedule C of the owner's federal tax return (Schedule F for a farm), and net income is reported on Line 12 for Business Income or Loss (Line 18 for Farm Income or Loss) of the state return.	The business files federal and state information returns. Federal return shows receipts and costs and both show income, deductions, and credits passed through to owners. Owners report their share of net business income from the pass-through as business income (Schedule E and Line 17 of the tax return for individuals). If the business receives dividends, capital gains, or other passive income, owners report those separately on the appropriate return lines.	The business files federal and state corporate income tax returns and a federal information report, Form 1099-DIV, for each owner who received at least \$10 of dividends. Owners report dividends received on their tax returns (Line 9 of state return for individuals).	Income is reported on owner's return.

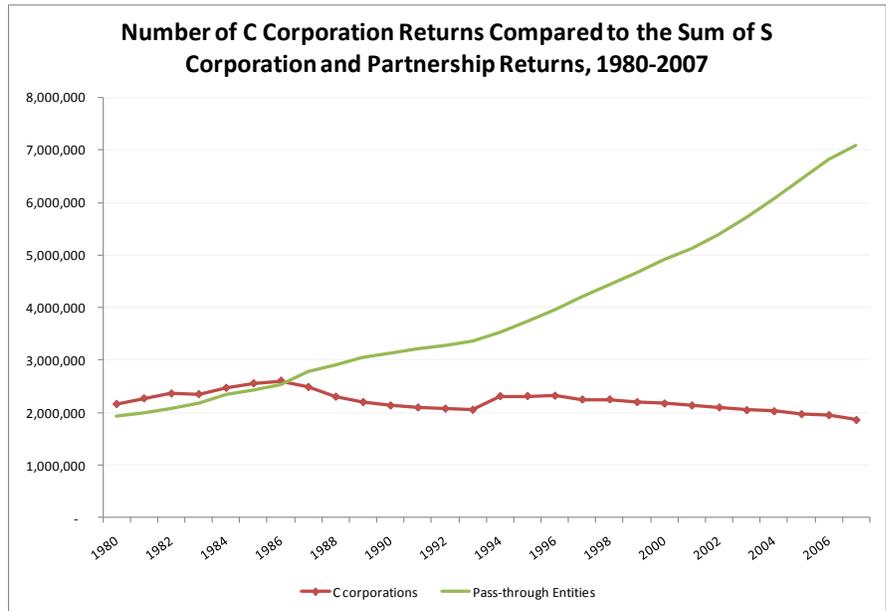
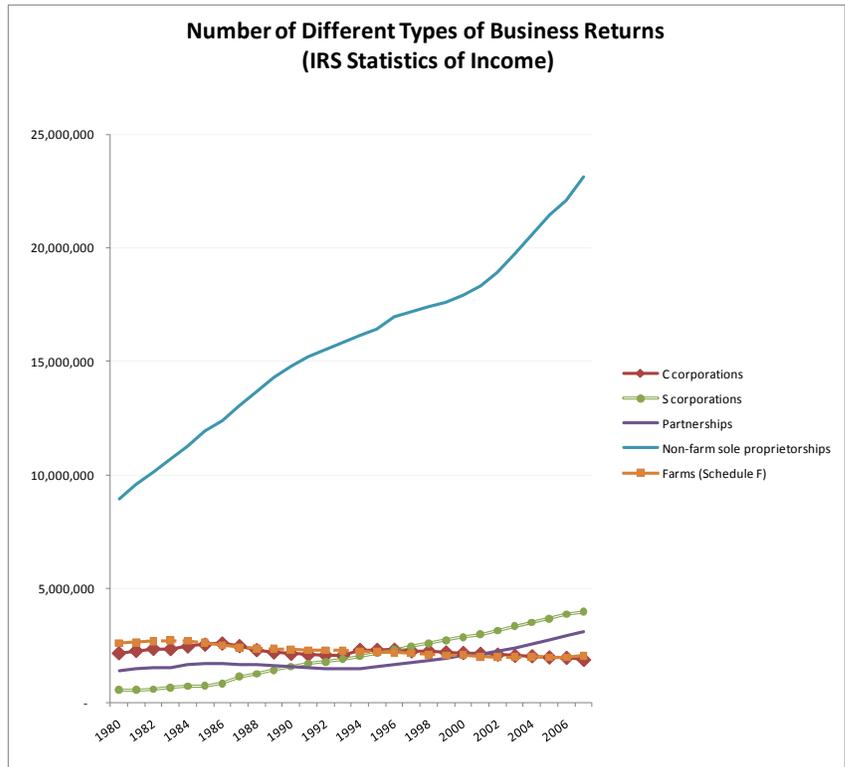
Growth of Pass-Through Entities

Increasingly, in Montana and nationwide, business and investment activities are being conducted by pass-through entities. The graph on the top right shows the number of returns filed with the IRS by business types from 1980 through 2007. As can be seen from the graph, non-farm sole proprietorships are the most common type of business entity in the U.S., based upon the number of returns filed. The number of non-farm sole proprietorships has been growing steadily over the time period, going from 9 million in 1980 up to 23 million in 2007, an average annual growth rate of almost 3.6%. The number of S corporations has also grown very rapidly during the same time – up from 545,000 in 1980 to almost 4 million in 2007, an annual growth rate of 7.6%. Partnerships grew more slowly – increasing from 1.4 million in 1980 to 3.1 million in 2007.

During the same period, both the number of corporation returns and farm returns (based upon schedule F) declined, with corporations going from 2.2 million in 1980 to 1.9 million in 2007 and farms (filing schedule F) going from 2.6 million in 1980 to 2.0 million in 2007. However, it should be noted that farms can also operate as partnerships or be incorporated as S or C corporations. Although they are not shown on the graph, the number of REIT and RIC returns also grew over this time period, going from 1,691 returns in 1980 to 13,724 returns in 2007.

The graph on the bottom left is based upon the same data as in the graph above, but compares the growth in the number of pass-through entities (partnerships and S corporations) to that of C corporations.

Sole proprietorships, just as the name suggests, are businesses with a single owner and are a familiar



sight on many main streets in Montana. The Department of Commerce, in its December 2007 publication, *Economic and Demographic Analysis of Montana*, reports that over 60% of Montana businesses are sole proprietorships without any employees. The owner of a sole proprietorship will record his or her income on the state individual income tax form, Form 2 on line 12, as Business Income (or loss), and will attach a copy of federal Schedule C (or C-EZ), which has been filed with the taxpayer's federal tax return. If the business owner has a farm or ranch operation that is operated as a sole proprietorship, the taxpayer reports his or her income on line 18 of the state individual income tax form (Farm Income or (loss)), and attaches a copy of federal Schedule F, which has been filed with the taxpayer's federal form.

One thing to note is that C corporations in Montana vary greatly in size – there are large or very large businesses that engage in operations across many states and even countries, but there are also smaller firms that engage in agricultural operations, main street businesses, or regional operations. Some of these may have been incorporated before S corporations were available or well understood; others may have been incorporated as C corporations in order to be better positioned to access capital markets or otherwise need one or more of the advantages that C corporation status provides. For example, S corporation shareholders pay tax on the entity's income, whether or not distributed. C corporation shareholders pay tax only on dividends distributed to them. It can be advantageous to a company that is growing to retain its earnings inside the corporation; however, for S corporation shareholders, this means that they may be taxed on income, but are not actually receiving any of that money.

Pass-Through Entity Returns

Income, Deductions and Credits Reported on Montana Pass-Through Returns

Pass-through entities that are classified as S corporations and partnerships for tax purposes are required to file information returns each year. These returns show the total amounts various types of income, deductions,

and credits allocated to the owners and the amount distributed to each owner. Pass-through entities that operate in more than one state apportion part of their income to Montana using the same apportionment formula as corporations. The following table shows Montana-source income allocated to owners on 2008 pass-through returns.

Montana-Source Income Passed Through To Owners, 2008 (\$ million)				
	S Corporations		Partnerships	
	Montana	Multi-State	Montana	Multi-State
Returns	21,607	3,996	16,508	3,424
Income Items				
Salaries and Other Fixed Payments to Owners	\$0.0	\$0.0	\$247.4	\$26.3
Ordinary Business Income	\$1,066.5	\$368.4	\$549.1	\$174.3
Rental Income				
Real Estate	\$24.6	\$5.4	-\$105.5	-\$1.1
Other	-\$5.8	\$6.0	-\$4.2	-\$2.4
Interest	\$47.2	\$13.0	\$958.6	\$31.0
Dividends	\$10.6	\$4.5	\$344.4	\$8.6
Royalties	\$7.4	\$8.1	\$88.8	\$19.9
Capital Gains	\$80.4	-\$56.8	\$447.2	\$21.4
Gains from the Sale of Business Property	\$134.3	\$376.4	\$228.8	\$108.0
Other Income	<u>\$16.4</u>	<u>\$1.6</u>	<u>-\$83.0</u>	<u>\$14.9</u>
Total	\$1,381.6	\$726.7	\$2,671.6	\$401.0
Montana Additions to Federal Income				
Interest on Non-Montana Municipal Bonds	\$1.3	\$2.4	\$3.7	\$0.4
State and Local Income Taxes	\$3.4	\$12.2	\$4.1	\$0.5
Other	<u>\$12.3</u>	<u>\$1.5</u>	<u>\$62.9</u>	<u>\$12.1</u>
Total	\$17.0	\$16.1	\$70.6	\$13.0
Montana Subtractions from Federal Income				
Interest on Federal Bonds	\$22.2	\$0.4	\$17.2	\$0.3
Purchases of Recycled Materials	\$0.2	\$0.0	\$0.0	\$0.1
Other	<u>\$10.6</u>	<u>\$14.4</u>	<u>\$96.6</u>	<u>\$14.9</u>
Total	\$33.0	\$14.8	\$113.8	\$15.3
Deductions				
Expensing of Capital Purchases	\$162.9	\$54.2	\$455.3	\$174.2
Contributions	\$20.4	\$6.6	\$20.4	\$1.8
Intest on Funds Borrowed to Make Investments	\$5.9	\$0.7	\$391.5	\$2.5
Other	<u>\$9.7</u>	<u>\$26.6</u>	<u>\$913.2</u>	<u>\$24.4</u>
Total	\$198.8	\$88.2	\$1,780.4	\$202.9
Total Net Montana Source Income	\$1,166.8	\$639.9	\$848.0	\$195.7

Pass-Through Entity Returns

Net income from the pass-through's business operations is usually allocated to the owners as ordinary business income. Individual owners report this income on Schedule E of their federal tax returns and then income from Schedule E is reported on Line 17 of their Montana Form 2. Income the pass-through receives from passive investments or the sale of assets is allocated to the owners as that type of income, and owners report it on the corresponding line of their tax returns. For example, if a pass-through receives \$1,000 of interest and allocates it equally to its ten owners, who are Montana individuals, each owner should report the \$100 of interest on Line 8a of their Form 2.

When a pass-through does something that is eligible for a tax credit, the credit is usually allocated to the owners who claim their share of the credit on their tax returns. Owners may or may not be able to claim the credit. For example, some credits can only be claimed by individuals, and some owners may have no taxable income to claim a credit against.

The following table shows credits reported on pass-through returns for 2008 as passed through to owners. Credits actually claimed by owners are included in the credits claimed for individual income tax and corpora-

Tax Credits Passed Through To Owners, 2008

	S Corporations		Partnerships	
	Montana	Multi-State	Montana	Multi-State
Dependent Care Credit	\$0	\$0	\$0	\$0
College Contribution Credit	\$12,644	\$955	\$1,275	\$609
Insurance for Uninsured Montanans Credit	\$250,574	\$6,040	\$30,553	\$0
Credit for Investment in Recycling Equipment	\$340,158	\$166,111	\$79,117	\$40,954
Alternative Energy Production Credit	\$0	\$0	\$0	*
Contractors' Gross Receipts Credit	\$17,334	\$0	\$18,510	\$9,703
Alternative Fuel Credit	\$3,245	\$0	\$0	\$0
Infrastructure Users Fee Credit	\$0	\$0	\$35,547	\$0
Charitable Endowment Contribution Credit	\$49,443	\$6,640	\$15,298	\$4,600
Historic Building Preservation Credit	\$0	\$1,346	\$0	\$0
Increased Research Activity Credit	\$95,108	\$97,501	\$2,253	\$6,828
Empowerment Zone Credit	\$0	\$0	\$0	\$0
Film Production Credit	\$23,891	\$12,062	\$0	\$14,328
Biodiesel Blending Credit	\$0	\$0	\$0	\$0
Oilseed Crushing Credit	\$0	\$0	\$3,455	\$0
Geothermal Heating System Credit	\$0	\$0	\$3,000	\$0
Insure Montana Credit	\$1,280,450	\$45,335	\$231,824	\$14,462
Temporary Emergency Lodging Credit	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
Total	\$2,072,847	\$335,990	\$420,832	\$91,484

Pass-Through Entity Returns

Income by Type of Owner 2008 (\$ million)

Type of Owner	S Corporations				Partnerships			
	Montana		Multi-State		Montana		Multi-State	
	Owners	Income	Owners	Income	Owners	Income	Owners	Income
Resident Individuals	34,875	\$872.5	1,454	\$238.5	34,977	\$335.1	1,366	\$28.6
Non-Resident Individuals	3,884	\$51.8	12,468	\$421.4	11,785	-\$67.5	24,810	-\$32.2
Montana Business Entities	405	\$22.0	23	\$21.7	4,094	\$183.4	247	\$39.0
Non-Montana Business Entities	<u>248</u>	<u>\$128.2</u>	<u>1,479</u>	<u>\$16.7</u>	<u>4,482</u>	<u>-\$109.7</u>	<u>16,670</u>	<u>\$80.3</u>
Total	39,412	\$1,074.5	15,424	\$698.3	55,338	\$341.3	43,093	\$115.7

tion license tax. The table below shows the numbers of reported owners who are individuals and business entities and who are located in Montana or in other states. It also shows the total income allocated to each group of owners.

Most of the owners of pass-through entities doing business only in Montana are Montana individuals. Most of the owners of multi-state pass-throughs doing business in Montana are non-Montana individuals, but about one-third of the partners in multi-state partnerships are non-Montana business entities.

Owners of pass-through entities taxed as partnerships may be either individuals or business entities. While

shares of S corporations can only be owned by individuals, some types of pass-through entities that can be owned by other business entities can elect to be treated as S corporations for tax purposes.

Most pass-through entities have a small number of owners. As the following table shows, more than 90% of pass-through entities have eight or fewer owners.

About four-fifths of entities with more than 20 owners are partnerships. S corporations are limited to 100 shareholders, while there are types of partnerships with one active partner who runs the business and many partners who are passive investors.

Pass-Through Entities - Number of Owners

Number of Reported Owners	S Corporations		Partnerships	
	Entities	%	Entities	%
1	11,358	45.9%	153	0.8%
2 to 3	10,880	43.9%	13,523	70.5%
4 to 8	2,033	8.2%	4,145	21.6%
9 to 20	359	1.5%	852	4.4%
Over 20	<u>128</u>	0.5%	<u>504</u>	2.6%
Total	24,758		19,177	

Tax Administration of Pass-Through Entities

Tiered Ownership and Tax Administration

A pass-through entity is not itself taxed. Instead, its income and expenses are reported in the tax returns of the owners. These owners can be corporations, individuals, other pass-through entities, or a mix of all of them. When pass-through entities are owned by other pass-through entities, a “tiered” business structure is created.

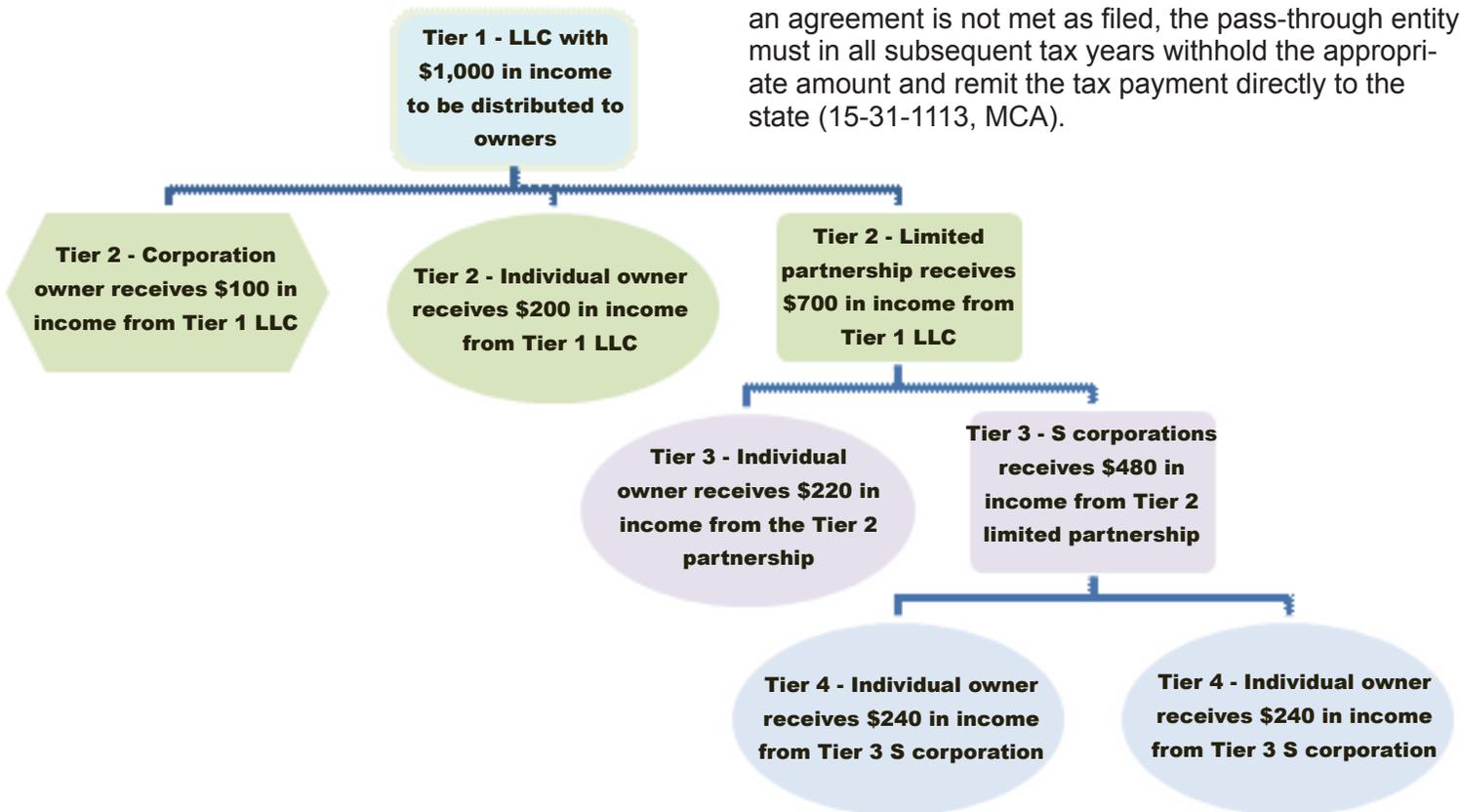
Tiered structures add complexity to tax administration because the “taxpayer” may be quite remote from the entity doing business in the state. Because pass-through entities can have either corporate, individual and/or another pass-through entity as a partner, owner or shareholder, they represent a challenge for tax administration. The following diagram shows how complex even a comparatively small set of ownership/partnership

relationships can become.

A pass-through entity with Montana source income must file an informational return. If this entity has a partner, shareholder, member or other owner who is a non-resident individual or a foreign C corporation, the pass-through entity is also required to:

- (1) file with the state an agreement with the individual nonresident to timely file a Montana return, pay taxes and be subject to personal jurisdiction of the state with respect to the income from the pass-through, or
- (2) file a composite return, or
- (3) remit tax on their shareholders behalf.

If there is a second tier pass-through owner, either a composite return has to be filed or withholding (unless that second tier pass-through proves that all of its shareholders are accounted for on Montana returns. If an agreement is not met as filed, the pass-through entity must in all subsequent tax years withhold the appropriate amount and remit the tax payment directly to the state (15-31-1113, MCA).



Sources:

Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* (JCX-48-08), June 4, 2008.

Internal Revenue Service, Statistics of Income.