BEFORE THE DEPARTMENT OF REVENUE
OF THE STATE OF MONTANA

In the matter of the amendment of ARM 42.15.219, 42.15.318, 42.15.403, 42.15.601, 42.15.602, 42.15.603, and 42.15.605 pertaining to pension and annuity income exclusions, dependent exemptions, and medical care savings accounts	)))))))	NOTICE OF PUBLIC HEARING ON PROPOSED AMENDMENT

TO: All Concerned Persons

1. On March 29, 2018, at 11 a.m., the Department of Revenue will hold a public hearing in the 3rd Floor Reception Conference Room of the Sam W. Mitchell Building, located at 125 North Roberts, Helena, Montana, to consider the proposed amendment of the above-stated rules. The hearing room is most readily accessed by entering through the east doors of the building facing Sanders Street.

2. The Department of Revenue will make reasonable accommodations for persons with disabilities who wish to participate in this public hearing or need an alternative accessible format of this notice. If you require an accommodation, contact the department no later than 5 p.m. on March 19, 2018, to advise us of the nature of the accommodation you need. Please contact Laurie Logan, Department of Revenue, Director's Office, P.O. Box 7701, Helena, Montana 59604-7701; telephone (406) 444-7905; fax (406) 444-3696; or e-mail lalogan@mt.gov.

3. The rules as proposed to be amended provide as follows, new matter underlined, deleted matter interlined:

42.15.219 PENSION AND ANNUITY INCOME EXCLUSION (1) For tax years beginning January 1, 2016, the pension and annuity exclusion is limited to the lesser of the pension and annuity income received or $4,070 for a single person or married couple where only one person receives pension or annuity income.

(a) The exclusion is reduced $2 for every $1 ~~over~~ of federal adjusted gross income in excess of $33,910 as shown on the taxpayer's return.

(b) By November 1 of each year, the department will multiply the exclusion amount and the federal adjusted gross income amount in (a) by the inflation figure for the taxable year as prescribed in 15-30-2110~~(14)~~, MCA.

(2) remains the same.

(3) When married taxpayers file separately, each spouse's exclusion and phase-out are computed independently and a spouse's exclusion begins to be phased out only when his or her federal adjusted gross income exceeds the amount allowed in (1)(a).

(4) Examples f~~or tax years beginning on or after January 1, 2016,~~ illustrating the application of (1) through (3) are:

(a) Jane, a single taxpayer, has federal adjusted gross income of $30,000

which is made up of $5,000 of pension income and $25,000 of other income. ~~Her~~ In 2016, her pension and annuity exclusion for Montana purposes is limited to $4,070.

(b) John, a married taxpayer, files separately from his spouse and has a federal adjusted gross income of $35,000, which consists of $17,000 of taxable pension income and $18,000 of other income. In 2016, John's Montana pension exclusion is reduced to $1,890 as a result of the limitation based on his federal adjusted gross income. ($4,070 - (($35,000 - $33,910) x 2)).

~~(b)~~(c) Frank and Edith, a married couple, file a joint income tax return and both receive pension and annuity income. Frank's taxable pension included in federal adjusted gross income is $10,000. Edith's taxable pension included in federal adjusted gross income is $2,000. Their combined federal adjusted gross income is $30,000. Their Montana pension and annuity exclusion is ~~$6,070~~ limited to their individual pensions. As a result, Frank receives ~~(~~the maximum $4,070 allowable in 2016 ~~for Frank and the full taxable amount of pension~~ and Edith ~~received is~~ receives $2,000~~)~~. ~~Even though their combined federal adjusted gross income is below $33,910, Edith is not entitled to a $4,070~~ The total they can claim as Montana pension exclusion ~~as the exclusion is limited to her taxable pension of $2,000~~ on their 2016 Montana tax return is $6,070.

~~(c) John, a single taxpayer, has federal adjusted gross income of $35,000. This consists of $17,000 of taxable pension income and $18,000 of other income. John's Montana pension exclusion is $1,890. ($4,070 - (($35,000 - $33,910) x 2)).~~

~~(d) John and Barbara, a married couple, file a joint income tax return and both report federal taxable pension income. John's federal taxable pension is $5,600 and Barbara's federal taxable pension income is $3,000. Their combined federal adjusted gross income is $37,500. Their combined Montana pension and annuity exclusion is $960. ($8,140 - (($37,500 - $33,910) x 2)).~~

(d) Assume the same facts as in (c), but Frank and Edith's 2016 federal adjusted gross income is $35,000. The reduction based on federal adjusted gross income applies, and their combined Montana pension annuity exclusion is $3,890. ($6,070 - (($35,000 - $33,910) x 2)).

AUTH: 15-30-2620, MCA
IMP: 15-30-2110, MCA

REASON: The department proposes amending ARM 42.15.219 to correct a grammatical error, update a statutory reference, and rework the layout of the examples in the rule.

The department proposes the grammatical change in (1)(a) to make the sentence easier to understand. The department also proposes removing the section identifier in the statute referenced in (1)(b). The current correct section number is (16), not (14). The section numbering within 15-30-2110, MCA, changed after the reference to it was placed in this rule. Because the statute reference remains relevant without identifying a specific section, the department proposes striking rather than replacing the section number to prevent this situation from occurring again in the future. The department also proposes separating the examples in (3) into a new (4), and revising them for better clarity. The separation and modification of the examples serves three purposes: It makes it clear that the examples pertain

to all previous sections of the rule and not only to (3); it clarifies that the exclusion amount and the federal adjusted gross income limitation used in the examples are for 2016 only, as these thresholds are adjusted for inflation; and, it explains the methodology to be used by taxpayers when filing jointly.

The amendments being proposed for this rule are housekeeping in nature and unrelated to any new legislation being addressed in this same rulemaking notice.

42.15.318 MONTANA NET OPERATING LOSSES (1) through (4) remain the same.

(5) The election to waive the carryback of a net operating loss on the federal return does not waive the carryback for Montana purposes and a separate election must be made. A taxpayer may elect to waive the carryback of a net operating loss even if the taxpayer has not made the election to waive the carryback on the federal return. The election to waive the carryback is made on ~~Form NOL, Montana Net Operating Loss~~ forms provided by or authorized by the department.

(6) remains the same.

AUTH: 15-30-2620, MCA
IMP: 15-30-2119, MCA

REASON: The department proposes amending ARM 42.15.318 to change the reference to the form on which a taxpayer must elect to waive the carryback period of the net operating loss. The rule currently identifies Form NOL as the document on which to make this election. At the request of tax preparers' associations, and in the framework of electronic filing, this requirement has become increasingly more difficult to fulfill. Therefore, the department is being receptive to the practical comments from preparers and proactive in simplifying the reporting process and moving this election to the main long form filed by taxpayers. In addition, a specific nomination of a form in the rule would require a subsequent amendment if the filing format were to evolve again. As a result, the reference to a specific form to report the election in (5) is proposed to be replaced by a general reference to forms provided by the department. This proposed change ensures that the department must provide a location on a form for this election without specification.

The amendment being proposed for this rule is unrelated to any new legislation being addressed in this same rulemaking notice.

42.15.403 EXEMPTIONS FOR DEPENDENTS (1) Except as provided in (2), a taxpayer is allowed a dependent exemption for each dependent who receives over half of his or her total support from the taxpayer. This support test must be implemented like the support test in 152(d)(1)(C) of the Internal Revenue Code (IRC), and all related U.S. Treasury Department regulations about qualifying relatives.

(2) A dependent exemption is not allowed for an individual described in (1):

(a) who, during the calendar year, has gross income of more than the exemption amount allowed under 15-30-2114, MCA; unless the individual is the

taxpayer's "qualifying child," as defined in section 152 of the IRC, and meets the support test for "qualifying child" under 152(c)(1)(D), of the IRC;

(b) remains the same.

(3) ~~Except as provided in (6), in~~ In lieu of the dependent exemption described in (1), a taxpayer is allowed ~~a dependent disabled child~~ an exemption ~~as provided in this section and (4), (5), (6), (7), and (8)~~ equal in amount to twice the dependent exemption for a qualifying dependent child with disability. ~~The exemption is allowed for a child who receives over half of his or her support from the taxpayer if:~~

(a) A child, meaning an individual whose relationship to the taxpayer conforms with the requirements in 152(C)(2) of the IRC, qualifies as a dependent child with disability for the purpose of applying 15-30-214, MCA, if:

(i) the child receives over half of his or her support from the taxpayer, as in (1);

~~(a)~~(ii) the taxpayer's home is the dependent disabled child's principal place of abode~~;~~, as determined by 152(c)(1)(B) of the IRC and related U.S. Treasury Department regulations; and

~~(b)~~(iii) a licensed physician has certified that the dependent child has a permanent disability constituting 50 percent or more of the body as a whole~~; and~~

~~(c) a licensed physician has certified the qualifying disability~~.

~~(4)~~(b) The taxpayer must ~~have a~~ provide the physician's certification ~~of qualifying disability that they retain as a tax record and provide the department upon request. In addition, the taxpayer makes the following representations when filing a return claiming a dependent disabled child exemption~~ with the first tax return on which they claim the disabled child exemption. If the taxpayer files electronically, and is unable to attach the certification to the electronic filing, it must be mailed to:

Department of Revenue
P.O. Box 5805
Helena, MT 59604-5805.

An exemption for dependent child with disability may be disallowed if the department has not received a copy of the physician's certification.

~~(a) if the taxpayer has filed the physician's certification with a prior year's return, the taxpayer represents there is no change in the dependent's physical circumstances to the extent the dependent no longer qualifies for the exemption; and~~

(c) To the extent the child continues to qualify as a dependent with disability, the taxpayer does not need to provide documentation with succeeding returns.

(d) The taxpayer must inform the department, in writing, of any change in the child's eligibility for this exemption, to be mailed to the address provided in (b). Any year the taxpayer does not claim this exemption on the return would satisfy this written obligation.

(e) In the instance that a child was no longer eligible for at least one year, and regains eligibility, the taxpayer must comply with the requirements in (b) with a new certification for the year the child qualifies again.

~~(b)~~(f) If, as of January 1, 2019, ~~if~~ the taxpayer has not ~~filed~~ joined the physician's certification with a prior year's return, ~~the taxpayer represents they have a copy of the certification of a licensed physician of a qualifying disability and there is~~

~~no change in the dependent's physical circumstances to the extent the dependent no longer qualifies for the exemption~~ and the child has continuously been eligible, the taxpayer must keep the certification in their records to be provided to the department upon request.

~~(5)~~(g) The dependent disabled child exemption may be claimed for a qualifying disabled child of any age ~~and may be claimed for a qualifying disabled child who is18 or older and has gross income equal to or more than the exemption amount allowed under 15-30-2114, MCA~~.

~~(6) A dependent disabled child exemption is not allowed for an individual who makes a joint return with his or her spouse.~~

~~(7) For all tax years the amount of the exemption, as adjusted for inflation for recent tax years, can be obtained by accessing past-year downloadable tax forms from the department's internet homepage web site located at: revenue.mt.gov.~~

~~(8) A taxpayer claiming a dependent disabled child deduction is required to notify the department if the child's physical circumstances have changed and the child no longer has a permanent disability constituting 50 percent or more of the whole body and of any other change in the child's eligibility for the dependent disabled child exemption. The notice must be in writing and mailed to:~~

~~Department of Revenue~~
~~P.O. Box 5805~~
~~Helena, MT 59604-5805~~

AUTH: 15-30-2620, MCA
IMP: 15-30-2114, 15-30-2115, 15-30-2116, ~~15-30-2152,~~ MCA

REASON: The department proposes amending ARM 42.15.403 to consolidate the sections of the rule pertaining to the dependent child with disability exemption together, and conform the meaning of some of the terms and requirements to the terms and requirements used in section 152 of the Internal Revenue Code (IRC), where applicable. In addition, the process requiring the taxpayer to provide a certification by a licensed physician when claiming the exemption for dependent child with disability, and inform the department of any change, is proposed to be redesigned to comply more closely with statute and clarify what actions undertaken by the taxpayer are necessary to fulfill this statutory requirement.

Due to the practical difficulty of distinguishing which authorities must be used to apply the requirements for dependents and dependent child with disability, the department proposes amending the rule to reference the federal meaning and guidance wherever possible. As a result, the term "child" must be understood the same way as a qualifying child under section 152 of the IRC. The support test has the same meaning as the support test for qualifying relatives in section 152(d) of the IRC, as the language is identical. The residency test to apply for the dependent child with disability is the same residency test that is applied in section 152(c) of the IRC, and bears the same exceptions.

To conform with a formality in the statute and increase compliance, the department will no longer allow taxpayers the option of retaining the required medical certification in their records for presentation to the department upon request

and will instead require the certification to be submitted along with the first return on which the exemption is claimed, as proposed to be set forth in newly numbered (3)(b).

For simplification, the language in newly numbered (3)(d) provides for the department to deem a lapse in claiming the exemption for dependent child with disability as sufficient written notice that the child is no longer eligible for the double exemption. Should the taxpayer subsequently claim the exemption following an interruption of at least one tax year, they will be required to submit a new certification from a licensed physician, as proposed in newly numbered (3)(e).

The department proposes removing the language that provides where to find the amount of exemption adjusted for inflation because it has become common for many figures used to determine taxable income to be adjusted for inflation annually. Therefore, it is no longer necessary to include this instruction in the rule.

The department also proposes removing the language in (6), which places a limit on the exemption when a married child with disability files jointly with their spouse, because 15-30-2116, MCA, does not provide support for this limitation in its alternative list of requirements. This type of limitation would need to be enacted by the legislature.

The department further proposes updating the implementing citations by adding 15-30-2115, and 15-30-2116, MCA, in support of the rule content and removing 15-30-2152, MCA, because it is unnecessary.

The amendments being proposed for this rule are unrelated to any new legislation being addressed in this same rulemaking notice.

42.15.601 MEDICAL CARE SAVINGS ACCOUNT ADMINISTRATOR REGISTRATION (1) through (6) remain the same.

AUTH: 15-30-2620, MCA
IMP: 15-61-204, MCA

REASON: The department proposes amending ARM 42.15.601 to insert the word "care" into the catchphrase for the rule for consistency with the language in statute. No other changes are being proposed for this rule.

42.15.602 MEDICAL CARE SAVINGS ACCOUNT ~~ADMINISTRATOR~~ REPORTING AND PAYMENTS (1) A Montana medical care savings account (MSA) is subject to the following requirements:

(a) The MSA must have a unique account holder who is an individual and a resident of Montana. A jointly held account does not qualify. Regardless of income tax filing status, married taxpayers must each open an account to register as an account holder to be eligible to reduce their federal adjusted gross income by the amount of their allowable contributions.

(b) Annual interest or income earned in a Montana MSA is excluded from Montana adjusted gross income as long as it remains as a deposit in the account, is withdrawn from the account to pay for eligible medical expenses, is distributed to an immediate family member as provided in 15-61-202, MCA, or is used for paying the expenses of administering the account. Year-end interest or other income reports

provided to the taxing authorities and the account holder must be provided in such a manner that the interest or other income earned on the Montana MSA can be separately identified in order to remain exempt.

(c) A taxpayer who used a loss in the value of the investment contained in the MSA as a reduction of their federal adjusted gross income, must add this loss back to the federal adjusted gross income for the determination of the Montana taxable income.

(d) Beginning January 1, 2018, an account holder cannot contribute in excess of the contribution limit stated in 15-61-202, MCA. During the 2018 calendar year only, any contribution made before January 1, 2018, in excess of the principal, which is the sum of contributions deducted from adjusted gross income in all preceding tax years, can be used as deductible contribution, as eligible expenses, or withdrawn free of tax and penalties. After December 31, 2018, an account holder cannot exclude from adjusted gross income any contribution in excess of the principal remaining in the MSA, and all unqualified withdrawals must be taxed as ordinary income and subject to the penalty as provided in 15-61-203, MCA.

(e) Before receiving any exempted transfer of funds from a Montana MSA of an immediate family member, a transferee must establish his or her own account, provided he or she is eligible to be an account holder of a Montana MSA.

~~(1)~~(2) Every account holder of a self-administered account, or account administrator, is required to annually submit the following information regarding each ~~medical savings account~~ MSA:

(a) through (c) remain the same.

(d) ~~deposits made during the tax year by~~ starting and ending balances of the account ~~holder~~;

(e) contributions made during the tax year by the account holder;

(e) and (f) remain the same, but are renumbered (f) and (g).

~~(g)~~(h) interest or other income earned on the principal of the ~~medical savings account~~ MSA; and

(h) remains the same, but is renumbered (i).

~~(2)~~(3) ~~The~~ Each individual account holder of a self-administered account must ~~also include~~ file the information required in (2) on forms provided by or authorized by the department and be remitted with the individual income tax form for the corresponding tax year. The account holder must report the name and address where the account is established, and the account number, annually.

~~(3) Both the contributions and any interest or other income earned on the account of a medical savings account are to be segregated by the account holder or account administrator from all other accounts.~~

~~(4) Each individual account holder must:~~

~~(a) establish a separate medical savings account with a financial or other approved institution; and~~

~~(b) segregate the account from all other accounts.~~

~~(5) Jointly held accounts do not qualify, although each spouse may be an account holder, regardless of income tax filing status. Each spouse would be allowed, within certain limitations, to reduce the federal adjusted gross income by the maximum allowable reduction of $3,000.~~

~~(6) Year-end interest reports provided to the taxing authorities and the~~

~~account holder must be provided in such a manner that the interest earned on that account can be separately identified.~~

~~(7) Annual interest earned on excess contributions and principal in a Montana medical care savings account is excluded from Montana adjusted gross income and may only be withdrawn from an account to pay for eligible medical expenses.~~

~~(8)~~(4) On or before January 31, an account administrator, other than an account holder, must file the information required under ~~(1)~~(2) on forms provided by or authorized by the department.

~~(9) Each individual account holder must file the information required in (1) on forms provided by or authorized by the department and be remitted with the individual income tax form for the corresponding tax year.~~

~~(10)~~(5) Account holders or account administrators who withhold penalties on ~~monies used for items other than eligible medical expenses or long-term care expenses~~ unqualified withdrawals must submit the penalties to the department as follows: ~~.~~

~~(11) Account holders and account administrators must remit the penalties monthly by the 15th day of the following month when the total amount of penalties exceed $500.~~

~~(12)~~(a) Account ~~holders and account~~ administrators ~~whose total penalties withheld during the calendar year are less than $500~~ must remit the penalties on or before January 31 of the following year to the department.

(b) Self-administered individual account holders must report and remit penalties with the individual income tax form for the corresponding tax year.

(13) remains the same, but is renumbered (6).

AUTH: 15-30-2620, MCA
IMP: 15-61-202, 15-61-203, 15-61-204, MCA

REASON: The department proposes amending ARM 42.15.602 to implement House Bill (HB) 175, L. 2017, which revised the tax exemptions and eligible withdrawals in the Montana medical care savings account (MSA) laws, and to reorganize the rule content into coherent and easy to read sections and eliminate redundancies. The department also proposes updating the catchphrase for the rule to better reflect the content as amended to include the filing and payment requirements for all accounts, not just accounts administered by a person other than the account holder.

Section (1) is proposed to be amended to compile the general requirements for all accounts together for ease of locating.

As proposed, new (1)(a) replaces current (4) and (5), pertaining to the requirement of having a unique distinct account per account holder. The new section stresses the importance of having one unique account per account holder. This is also true for married couples, so that each spouse may keep their account in case of divorce. It also facilitates the transfer of the account balance to another beneficiary than the spouse in case of death.

As proposed, new (1)(b) regroups current (3), (6), and (7), and pertains to the treatment of interest and other income yield by the funds on the account. The

reference to excess contribution proposed to be removed from (7) is now addressed in (1)(d).

As proposed, new (1)(c) provides that any loss from the investment reported for federal tax purposes must be added back to Montana adjusted gross income in accordance with 15-61-202, MCA.

As proposed, new (1)(d) transitions to the new provisions passed by the 2017 Legislature, which amended 15-61-202(2), MCA. The legislature substituted what was initially a deduction limit, with a contribution limit. By posing the principle of equivalence between contribution and deductibility, the legislature has leveled the playing field for all taxpayers regarding the deductibility of medical expenses. In addition, the provision formerly located in 15-61-202(4), MCA, allowing the deduction of excess contributions in future years, has been eliminated from the statutes. As a result, excess contributions which were not deducted before 2018 are at risk of being taxed twice, once before the contribution was made and a second time when withdrawing the funds from the account for other purposes than eligible expenses. Thus, a transition period must be introduced to provide a fair tax treatment for excess contributions for which the deduction was suspended to a future date. Section (1)(d) also provides for a period of one calendar year during which taxpayers can withdraw any excess contribution made before January 1, 2018, tax free. Account holders will still be allowed to either use all or part of this excess as a contribution deductible in 2018, or as a withdrawal to pay eligible medical expenses. After 2018, any withdrawal for purposes other than eligible expenses will be subject to the tax set forth in 15-61-203, MCA.

As proposed, new (1)(e) clarifies what a transferee must do to benefit from the exemption in case of a transfer to an immediate family member. Establishing an account as an eligible account holder avoids any reclassification of an account after the fact, which would constitute a breach of the reporting requirements.

As proposed, new (2) restates the filing requirements that are found in current (1). The proposed amendment adds the new requirement to annually report the starting balance and ending balance of a medical care saving account to the department, as enacted by HB 175 in 15-61-204(6), MCA.

As proposed, (3) regroups current (2) and (9), as they both pertain to account holders specifically.

As proposed, new (5) pertains to the remittance of penalty to the department by account administrators and account holders. This section regroups current (10) and (12). Current (11), which pertains to the payment of penalties over $500 monthly, is proposed to be eliminated for simplification. Penalties of such amounts are extremely rare and, as a result, the cost incurred to provide a specific reporting requirement exceeds the benefits of collecting the penalty in advance of the yearly reporting required for administrators or account holders.

Current (8) and (13) remain the same but are being renumbered as (4) and (6), respectively, as part of the overall restructuring of the rule.

The department also proposes adding 15-61-203, MCA, as an implementing citation in support of the rule as amended.

<u>42.15.603 MEDICAL CARE SAVINGS ACCOUNT - WITHDRAWALS, PENALTIES, AND TRANSFERS</u> (1) The funds held in a <u>Montana</u> medical <u>care</u>

savings account (MSA) may be withdrawn by the account holder free of tax at any time during the year if they are qualified withdrawals ~~for eligible medical expenses paid during that year. Withdrawals for the purpose of paying eligible medical expenses shall not be subject to the 10 percent penalty~~.

(2) Except as provided in (7), qualified withdrawals include:

(a) eligible medical expenses, as defined in 15-61-102, MCA, paid during that year; or

(b) expenses incurred for administering the account.

(3) An unqualified withdrawal must be:

(a) included in the taxpayer's income tax return as ordinary income; and

(b) is subject to a penalty equal to 10 percent of the amount of the withdrawal from the account. An unqualified withdrawal made on the last business day of the business year, as set forth in 15-61-203, MCA, is not subject to this penalty but shall be taxed as ordinary income as provided in (a).

(4) Withdrawals that do not meet the following requirements and exceptions are deemed unqualified:

(a) Withdrawals must be made by the account holder of a self-administered account, or on behalf of an account holder, by January 15 for the purpose of reimbursing eligible medical expenses paid during the previous year.

(b) Each account holder must maintain documentation of eligible expenses for a minimum of three years from the date the account holder filed a Montana income tax return for the year the expenses were incurred.

~~(2)~~(c) ~~Requests~~ In the case of requests made by account holders from account administrators for withdrawals to pay for eligible medical expenses, the expenses must be supported by an itemized statement of expenses that were either paid or charged by the account holder and the signature of the account holder attesting that these expenses are "eligible medical expenses." ~~An eligible medical expense means any medical expense that is deductible for purposes of section 213(d) of the IRC.~~

~~(3)~~ The burden of proving that a withdrawal from ~~a medical savings account~~ an MSA was made for an eligible ~~medical~~ expense is upon the account holder and not upon the account administrator. ~~Each account holder must maintain documentation of eligible medical expenses.~~

~~(4) There shall be a penalty for withdrawal of funds by the account holder for purposes other than the payment of eligible medical expenses except upon the death of the account holder. The penalty shall be 10 percent of the amount of the withdrawal from the account and, in addition, the amount withdrawn shall be taxed as ordinary income.~~

~~(5) The direct transfer of funds from a medical savings account to a medical savings account with a different account administrator shall not be considered a withdrawal for purposes of this rule. A direct transfer is when monies in an account are transferred to a new account without the beneficiary or account holder receiving any funds.~~

~~(6) Withdrawals made on the last weekday in December are not subject to the 10 percent penalty but shall be taxed as ordinary income.~~

~~(7) Withdrawals made by January 15 by the account holder of a self-administered account for the purpose of reimbursing eligible medical expenses paid after December 1 of the previous year are qualifying withdrawals and are not subject to~~

~~tax or the 10 percent penalty.~~

~~(8)~~(d) ~~Except as provided in (9), all~~ All payments made from ~~a medical account~~ an MSA must be made payable to the account holder, ~~to~~ the eligible medical provider, ~~or to~~ the estate, or ~~to~~ the legal guardian of the account holder, unless an agreement exists between the account holder and/or the account administrator and the payee to pay eligible medical expenses electronically.

~~(9) If an agreement exists between the account holder, account administrator, and the payee, withdrawals for eligible medical expenses can be done electronically.~~

(5) An account holder who becomes a resident of another state is deemed to have made an unqualified withdrawal for the entire value of the balance contained in the account on the date the individual changed residency. The withdrawal is deemed to have been made on the last business day of the taxpayer's Montana residency, and is not subject to the 10 percent penalty provided in 15-61-206, MCA.

(6) The direct transfer of funds from a Montana MSA of an account holder to another Montana MSA is deemed an unqualified withdrawal to the transferor and ordinary income to the transferee, to the extent it is includable in the transferee's federal gross income, except when the funds are directly transferred to:

(a) another Montana MSA of the same account holder established to replace the initial one or with a different account administrator; or

(b) a Montana MSA held by an immediate family member of the account holder, to the extent it is not includable in the transferee's federal gross income.

(7) After the death of the account holder:

(a) any distribution or withdrawal of funds from the Montana MSA is deemed an unqualified withdrawal unless:

(i) the funds are distributed as an inherited account; or

(ii) the withdrawals are made during the 365 days following the death of the account owner, either by the estate of the deceased on an existing account, or by any account holder of an inherited account to pay for eligible expenses incurred by the deceased;

(b) inherited accounts are deductible from Montana adjusted gross income to the extent they are included in the federal adjusted gross income; and

(c) the 10 percent penalty for unqualified withdrawals does not apply to any distribution of funds to the heirs of the deceased whether or not the funds received qualify as an inherited account.

(8) Qualified withdrawals made with respect to a family leave expense, as defined in 15-61-102, MCA, are deemed to be in exchange of adequate consideration for loss of income and must be treated as ordinary income to the recipient, except when received by the account holder or the spouse of the account holder.

~~(10)~~(9) All medical records and expenses provided by an account holder to an account administrator are to be kept confidential by the account administrator unless the account holder gives authorization to disclose them to a third party.

AUTH: 15-30-2620, MCA
IMP: 15-61-102, 15-61-202, 15-61-203, MCA

REASON: The department proposes amending ARM 42.15.603 to implement the changes made to the statute by House Bill (HB) 175, L. 2017, which revised the tax

exemptions and eligible expenses in the Montana medical care savings account (MSA) laws, and to reorganize the rule content to better clarify the treatment of funds in a Montana MSA when the account holder changes jurisdiction, in the case of transfer of the account assets in some circumstances, or passes away.

In the proposed reorganization, current (2), (3), (7), (8), and (9) will become new (4); current (4) and (6) will become new (3); current (5) will become new (6) and be expanded; and current (10) will become new (9).

This proposed reorganization of the rule content is intended to help taxpayers distinguish the sections pertaining to withdrawals, in general, from withdrawals stemming from the intention to transfer property from the account holder to another Montana MSA. Withdrawals are divided between qualified and unqualified withdrawals. This distinction drives the tax treatment of the withdrawals for the account holder or in case of transfer, for the transferee.

New (5) is proposed to be included in the rule to clarify the treatment of Montana MSAs owned by an individual who establishes residency in another state. This situation is covered by the statute indirectly. Section 15-61-102(2), MCA, provides that an account holder means an individual who is a resident of Montana. As a result, a nonresident cannot be an eligible account holder, and the account itself loses its Montana tax attributes under the statute. In other words, the account can no longer be regarded as a Montana MSA. When this is the case, the balance on the date the individual changes residency becomes an unqualified withdrawal, and the balance in the account must be reported as ordinary income.

This recapture is the consequence of the limits attached to Montana jurisdiction. When residents move to another state, earnings from investments are no longer Montana source income and their payments do not trigger any filing requirements in the state. As a result, Montana has no legal or administrative means to verify the use of the funds when received by a nonresident. Not recapturing the income previously deducted would result in a permanent exemption regardless of the usage of the funds after the change in residency and would introduce a double standard regarding eligible expenses.

Recognizing that the establishment of residency in another state is not motivated by the tax treatment of the exempted income contained in the Montana MSA, proposed new (4) exempts this recapture from the 10 percent penalty.

New (6), formerly (5), is proposed to be expanded to clarify the tax treatment of a transfer from a Montana MSA to another Montana MSA by means of a direct transfer. The newly numbered section, as amended, treats a direct transfer as an unqualified withdrawal, and therefore taxable and subject to the 10 percent penalty except when exempt.

To reflect the exemption for transfers of funds from one account holder to the MSA account of an immediate family member, as provided for in 15-61-202(4), MCA, (6) provides two exceptions reflecting the exemption provided in the statute. However, (6) also introduces a new limitation to the statutory exemption when the funds transferred from one account to the other represents payment of a taxable compensation to a family member. Essentially, the exemption provided by the statute must reflect treatment as a gift, not as a regular business transaction.

As proposed, new (7) lays out the tax treatment of withdrawals from an MSA after the death of the account holder. Section 15-61-202(7), MCA, does not exempt

the transfer of the funds after the death of the account holder; instead it exempts some transfers, when the account is transferred to an immediate family member, or when monies from the account are used to pay for eligible expenses incurred by the deceased. To avoid the situation in which funds would be kept purposely in an MSA to pay ineligible expenses after the death of the account holder, (7) assimilates transfers after the death of the account holder as an unqualified withdrawal that is taxable.

The transfer of an MSA to an immediate family member after the death of the first account holder is exempt for Montana tax purposes. This is consistent with 15-61-202(4), MCA, which already contained this exemption. However, this exemption also depends on the fact that the heir is a resident of Montana. When the recipient is a non-resident, regardless of whether it is an immediate family member or not, the exemption cannot apply because the heir cannot contribute the funds to a Montana MSA. As a result, the rule uses the definition of an inherited account provided in ARM 42.15.603 to limit the exemption to heirs that are eligible to open an MSA. A nonresident heir inheriting the content of an MSA is similar to having an account holder moving out of the state. As a result, the tax treatment remains consistent across the program.

A second exemption is included in 15-61-202(7), MCA, for the payment of medical expenses by the heir who is the account holder of an inherited account. This exemption is extended to the administrator of the estate of the deceased managing the account while the distribution of the estate is pending, regardless of whether the funds of the MSA would eventually be transferred as an inherited account or not, for simplicity. This allows the administrator of the estate to pay any medical debt before the effective distribution of the funds.

As proposed, new (7) keeps the principle already in force in current (4), according to which the transfer of an account for cause of death of the account holder is not subject to the 10 percent penalty.

As proposed, new (8) provides that when the account holder makes a qualified withdrawal with respect to a family leave expense, the funds received by the recipient, when it is neither the account holder nor the spouse of the account holder, is ordinary income. The statute remains silent regarding who applies to an FMLA leave, and only addresses the effect of such withdrawal for the account holder. Yet, for income tax purposes, such a transfer would be regarded as a gift if it was not for compensating a loss of revenue stemming from the FMLA leave. This payment is similar to an unemployment insurance compensation and is regarded as ordinary income. Montana statute does not provide for an exemption in this case.

The department further proposes updating the rule catchphrase to more accurately reflect the content of the rule as amended; and adding 15-61-102 and 15-61-202, MCA, as additional supportive implementing citations for the rule.

42.15.605 DEFINITIONS The following definitions apply to this subchapter:

(1) "Account administrator" means, in addition to the definition found in 15-61-102, MCA, any person, partnership, limited liability company, limited liability partnership, or corporation that acts as a ~~third party~~ third-party fiduciary to administer a medical care savings account and is either a bank, savings and loan, credit union, or trust company, a health care insurer, a certified public accountant, or an employer who is self-insured under ERISA.

(2) remains the same.

(3) "Direct transfer" means a withdrawal of all or part of a Montana medical care savings account (MSA) that is deposited in its entirely by means of an electronic bank transfer or by means of check into another Montana MSA.

(3) remains the same, but is renumbered (4).

~~(4) "Long-term care" means necessary or medically necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance, or personal care provided for a period of no fewer than 12 consecutive months in a setting other than an acute care unit of a hospital.~~

~~(5) "Recovery" means the return or recoupment of amounts that were previously deducted in Montana taxable income or credited against Montana tax in any prior taxable year.~~

(5) "Inherited account" means funds coming from a Montana medical care savings account (MSA) of a deceased individual, inherited by an immediate family member and contributed to the heir's Montana MSA upon distribution of the estate or as pay-on-death beneficiary of the account.

(6) "Self-administered" ~~refers to~~ means accounts that are administered by the account holder for their own benefit.

AUTH: 15-30-2620, MCA
IMP: ~~15-30-2114,~~ 15-61-102, 15-61-201, MCA

REASON: The department proposes amending ARM 42.15.605 to implement the changes enacted by House Bill (HB) 175, L. 2017, which revised the tax exemptions and eligible expenses in the medical care saving account laws, and to apply the provisions in ARM 42.15.602 and 42.15.603, as proposed to be amended in this same rulemaking notice.

The department proposes striking (4), because HB 175 removed the term "long-term care" from statute because this type of care is covered in the federal statute as qualified expenses. Therefore, it no longer needs to be defined by rule. The department also proposes striking (5), because the term "recovery" is no longer used in any of the department's rules related to the Montana medical care savings account (MSA).

The department proposes defining the term "direct transfer," to simplify the description of transfers of funds from one MSA holder to another MSA holder, and the term "inherited account," to distinguish inherited accounts from direct transfers, because inherited funds must often transit through an account owned by the estate before being distributed to the heirs. Both terms are used in ARM 42.15.603, as proposed to be amended in this same rulemaking notice.

The department further proposes striking 15-30-2114, MCA, from the implementing citations for the rule because it is unnecessary.

4. Concerned persons may submit their data, views, or arguments, either orally or in writing, at the hearing. Written data, views, or arguments may also be submitted to: Laurie Logan, Department of Revenue, Director's Office, P.O. Box 7701, Helena, Montana 59604-7701; telephone (406) 444-7905; fax (406) 444-3696; or e-mail lalogan@mt.gov and must be received no later than April 11, 2018.

5. Laurie Logan, Department of Revenue, Director's Office, has been designated to preside over and conduct this hearing.

6. The Department of Revenue maintains a list of interested persons who wish to receive notices of rulemaking actions proposed by this agency. Persons who wish to have their name added to the list shall make a written request that includes the name and e-mail or mailing address of the person to receive notices and specifies that the person wishes to receive notice regarding a subject matter or matters. Notices will be sent by e-mail unless a mailing preference is noted in the request. A written request may be mailed or delivered to the person in 4 above or faxed to the office at (406) 444-3696, or may be made by completing a request form at any rules hearing held by the Department of Revenue.

7. An electronic copy of this notice is available on the department's web site revenue.mt.gov, or on the Secretary of State's web site sos.mt.gov/ARM/register.

8. The bill sponsor contact requirements of 2-4-302, MCA, apply and have been fulfilled. The primary sponsor of House Bill 175, L. 2017, Representative Jim Hamilton, was contacted by regular mail on June 14, 2017, and January 24, 2018.

9. Regarding the requirements of 2-4-111, MCA, the department has determined that the amendment of the above-referenced rules will not significantly and directly impact small businesses. Documentation of this determination is available at revenue.mt.gov or upon request from the person in 4.

/s/ Laurie Logan
Laurie Logan
Rule Reviewer

/s/ Mike Kadas
Mike Kadas
Director of Revenue

Certified to the Secretary of State February 13, 2018.