

BEFORE THE DEPARTMENT OF REVENUE
OF THE STATE OF MONTANA

In the matter of the adoption of New Rule I pertaining to the deduction provided under IRC 199A - not allowed for the determination of Montana net income) NOTICE OF ADOPTION
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TO: All Concerned Persons

1. On June 22, 2018, the Department of Revenue published MAR Notice No. 42-2-995 pertaining to the public hearing on the proposed adoption of the above-stated rule at page 1153 of the 2018 Montana Administrative Register, Issue Number 12.

2. On July 23, 2018, a public hearing was held to consider the proposed adoption; no proponents or opponents were present and no oral testimony was received. The department received written comments from Walter J. Kero, CPA, of Kero, Byington & Associates, CPAs.

3. The department adopts New Rule I (42.15.527) as proposed.

4. The department has thoroughly considered the comments received. A summary of the comments received and the department's responses are as follows:

COMMENT #1: Mr. Kero's initial comments involve statements of opinion that the department is incorrect in its interpretation that the Qualified Business Income (QBI) reduction, found in Section 199A (§ 199A) of the Internal Revenue Code (IRC), as amended by the United States Congress (Congress) under the Tax Cuts and Jobs Act of 2017 (TCJA), is not allowed in the determination of Montana net income. Mr. Kero states that his comments are a formulation of his opinion on the effects that § 199A will have on Montana taxpayers.

RESPONSE #1: The department thanks Mr. Kero for providing the context and background for his opinion, but disagrees that the department's interpretation of the effects of the TCJA is incorrect.

COMMENT #2: Mr. Kero comments that the disallowing the § 199A reduction on state tax returns will have a significant impact on taxpayers' tax liability and that the reduction should be allowed under existing Montana laws and regulations.

RESPONSE #2: The department thanks Mr. Kero for his comments regarding the significance of disallowing the § 199A reduction on taxpayers' tax liability. Whether the impact is significant or not is dependent on each taxpayer and that taxpayer's tax situation.

The department disagrees that existing Montana law provides support for § 199A. Section 15-30-2620(2), MCA, indicates: "If a term is not defined in this chapter, the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code." For the department to apply § 199A as Congress defined it, there would have to be a comparable context to which it can be applied. Prior to the TCJA, Montana had two types of below-the-line deductions: (1) deductions allowed in computing net income (15-30-2131, MCA); and (2) the standard deduction (15-30-2132, MCA). The TCJA creates a new deduction that is specifically excepted from IRC § 63 itemized deductions. This new deduction is not present in Montana law; therefore, there is no "comparable context" to which the department can apply the definition. For this reason, the department finds it necessary to adopt New Rule I.

COMMENT #3: Mr. Kero objects to the department's interpretation of federal language which the department states in the reasonable necessity for the rulemaking. Mr. Kero believes "impacts" is not correct, and that "conflict" is more appropriate regarding the federal law's influence upon Montana.

Mr. Kero further commented that Congress intended IRC § 63 to allow the states "to adopt 199A or not adopt 199A" and to provide "a choice regarding the business deduction." In other words, whether to allow the deduction should be an action of the Montana Legislature.

RESPONSE #3: The department disagrees with Mr. Kero's interpretation of what words to use in the statement of reasonable necessity and opines its interpretation is correct, that Congress intended § 199A to apply initially to federal returns, and the department appropriately stated the rule's necessity ". . . because the deduction was placed under IRC Section 63 as a standalone reduction of federal taxable income, and was not intended to impact states that use federal adjusted gross income as a starting point for calculating state individual income tax."

However, the department agrees that the Legislature may take up the issue of interpretation of § 199A if it determines the language Congress provided to the states is ambiguous.

As for Mr. Kero's other comments regarding congressional intent in adopting the new federal law, the department will not address those matters here as they fall outside the scope of this rulemaking.

COMMENT #4: Mr. Kero commented that the rule is not supported by, or agrees with, any existing law and does the opposite of 15-30-2602, MCA.

RESPONSE #4: The department does not agree. See Response #2, paragraph 2.

COMMENT #5: Mr. Kero comments that IRC § 199A is a business deduction, not a "personal, itemized deduction."

RESPONSE #5: While the QBI is termed a "deduction," the department has concluded that it operates as an exemption from income. In his letter, Mr. Kero

asserts that QBI is not a "personal, itemized deduction," yet he agrees with the department that it functions as an exemption. If the department were to adopt the interpretation that QBI should be treated as a deduction, this would be substituting form over substance. Further, if QBI is applied as a deduction, all expenses associated with the production of exempt income would have to be disallowed, which may leave Montana taxpayers in a worse situation than if they had not claimed a deduction. It is the conclusion of the department, therefore, that the QBI should be treated as an exemption.

COMMENT #6: Mr. Kero made several comments and statements of opinion regarding his review of a department legal memorandum regarding the department's review, interpretation, and guidance regarding the implementation of the TCJA and § 199A. The memorandum-based comments are a combination of agreement or acknowledgement of the department's conclusions and disagreement, primarily, with the department's final memorandum conclusion ". . . that the history of adoption of the federal definition for 'itemized deductions' in § 63(d), as applied to Montana, would disallow IRC 199A deductions for state tax purposes."

RESPONSE #6: The department appreciates the comments and opinions expressed by Mr. Kero, as well as his extensive tax and accounting experience. However, the department contends these tertiary comments have been discussed above, and the department will not address other comments that fall outside the scope of the rulemaking.

/s/ Todd Olson
Todd Olson
Rule Reviewer

/s/ Gene Walborn
Gene Walborn
Director of Revenue

Certified to the Secretary of State November 7, 2018.