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Senator Fred Thomas
1004 South Burnt Fork Road
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Dear Majority Leader Thomas:

This memorandum is in response to your request for a legal opinion regarding whether newly enacted Internal Revenue Code section 199A can be claimed as a state itemized deduction under section [15-30-2131](#), MCA. As part of your question, you specifically asked me to analyze a Department of Revenue ("Department") internal¹ memorandum of legal advice dated December 28, 2017, and supplemented January 4, 2018, regarding this subject.

Before I provide you with my opinion and analysis, a caveat is necessary. Due to the constitutional constraints inherent in the separate powers of each branch of state government, a legal opinion provided to you by a Legislative Branch attorney is obviously not binding on the Department as an Executive Branch agency.

Parts 1 and 2 of the legal analysis for this memorandum provide a general overview of the Montana individual income tax system as a matter of background. If you do not desire to read the background material, you can find the legal analysis for your question in part 3 of the legal analysis.

QUESTION PRESENTED

Do reasonable grounds exist for a court to conclude that the newly enacted section 199A deduction is not available as a Montana itemized deduction?

SHORT ANSWER

Yes. The federal government's recent enactment of the Tax Cuts and Jobs Act changes the landscape of the federal income tax. Since most states adopt provisions of the Internal Revenue Code, there will also be changes to the tax laws of several states. Montana is not unique in this regard. However, Montana is somewhat unique in the way it determines what specific federal itemized deductions are available as state itemized deductions. This is relevant, as Congress recently enacted a new section 199A deduction that allows certain taxpayers with pass-through income to claim a deduction on a federal return for certain qualified business income. In adopting the new deduction, Congress expressly declared that it is not used in determining federal adjusted

¹The memorandum is addressed to the Director of the Department of Revenue from Tax Counsel. Internal memorandums lack the force of law granted to administrative rules. See section [2-4-102](#)(14), MCA.

gross income, federal itemized deductions, or the federal standard deduction. Nevertheless, the Department's internal memorandum concludes that the new section 199A deduction can be claimed as a state itemized deduction. This conclusion is based on the manner in which Montana adopted certain federal itemized deductions decades ago, without adopting the federal definition for "itemized deductions" in section 63 of the Internal Revenue Code. Had Montana adopted the definition in section 63, then the potential issue would not exist. This memorandum challenges the conclusion that a section 199A deduction is available in Montana.

First, from a historical standpoint Montana has utilized the federal definition for "itemized deductions" in section 63 of the Internal Revenue Code by restricting the deductibility of state itemized deductions. This approach is defensible, as state statute permits the utilization of Internal Revenue Code definitions when a term is not defined in the Montana Code Annotated. Given that Montana has already utilized the federal definition for "itemized deductions" it could likewise follow the same line of reasoning to deny the section 199A deduction. (*See* Subpart 3.B)

Second, the statute in which Montana adopts certain federal itemized deductions could be interpreted in a manner in which federal deductibility is a prerequisite to state deductibility. To find otherwise would mean that the state would be required to allow deductions that are not allowable at the federal level. Such an interpretation does not fit the purpose of adopting a federal code. (*See* Subpart 3.C)

Finally, deductions are a matter of legislative grace. Pursuant to state statute, all income is taxable unless expressly provided. A reasonable argument can be asserted that the section 199A deduction is not expressly provided. Moreover, based on existing Montana Supreme Court precedent a court could declare that treating section 199A as an itemized deduction results in the statute is being applied in a manner that results in unlawful delegation of legislative authority. (*See* Subpart 3.D).

LEGAL ANALYSIS

1. ROLLING CONFORMITY AND THE NEWLY CREATED SECTION 199A QUALIFIED BUSINESS INCOME DEDUCTION

The structure of Montana's personal income tax is based on federal tax law. This structure is not uncommon. According to a recent report from the National Conference of State Legislatures, "[m]ost state tax codes conform to the federal tax code in terms of how they define income."² As such, whenever Congress adds another exclusion or deduction, the same feature can automatically appear (i.e., rolling conformity) in the Montana income tax without any action from the Legislature. There are 22 other states that use rolling conformity, while 17 states have

² National Conference of State Legislatures (NCSL), [Federal Tax Reform and the States](http://www.ncsl.org/research/fiscal-policy/federal-tax-reform-and-the-states.aspx), available at <http://www.ncsl.org/research/fiscal-policy/federal-tax-reform-and-the-states.aspx> (last visited Jan. 5, 2018).

static conformity, which means they must adopt federal changes that are desired.³

When a reference appears to a specific provision of the Internal Revenue Code it encompasses "those provisions as they may be otherwise labeled or further amended."⁴ Additionally, in the event a term is not defined in Montana law "the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code".⁵

On December 22, 2017, the [Tax Cuts and Jobs Act](#)⁶ ("H.R. 1") was signed by the President and became law.⁷ The enacted version of the bill is 185 pages long and impacts the federal income tax system in a variety of ways. A large portion of the changes to the federal individual income tax code are temporary and expire at the end of 2025.⁸ Instead of analyzing all the federal changes, the focus of this memorandum is limited to an analysis of whether a new federal Internal Revenue Code provision titled Qualified Business Income ("QBI") and enacted in section 199A of the Internal Revenue Code is a Montana itemized deduction. If allowable, the new deduction could result in certain taxpayers claiming a deduction at the state level in an amount up to 20% of QBI received by a taxpayer from a pass-through entity starting in tax year 2018.

Department legal counsel reviewed the issue of whether the new section 199A deduction impacts the Montana income tax in an internal memorandum of legal advice to the Director of the Department dated December 28, 2017, and supplemented January 4, 2018. The internal memorandum concludes that taxpayers who itemize their Montana deductions will be able to claim the section 199A deduction for QBI when computing their Montana income tax.

2. OVERVIEW OF THE MONTANA INDIVIDUAL INCOME TAX

A. Gross Income Calculation

The Montana income tax starts by adopting the federal concept of gross income. Pursuant to section [15-30-2101](#), MCA, gross income "means the taxpayer's gross income for federal income tax purposes as defined in section 61 of the Internal Revenue Code (26 U.S.C. 61) or as that section may be labeled or amended", excluding certain unemployment compensation. Section

³ *Id.*

⁴ Section [15-30-2101](#), MCA.

⁵ Section [15-30-2620\(2\)](#), MCA.

⁶ [Public Law No. 115-97](#), available at <https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf> (last visited Jan. 9, 2018).

⁷ See [H.R. 1's Bill History](#), available at <https://www.congress.gov/bill/115th-congress/house-bill/1>

⁸ NCSL, *supra* note 2.

61(a) of the Internal Revenue Code, in turn, provides that unless provided otherwise gross income "means all income from whatever source derived". The United States Supreme Court, in *Commissioner v. Glenshaw Glass Co.*⁹, determined that the definition of gross income is broad and that Congress intended to exert "the full measure of its taxing power". Likewise, the Montana definition of gross income is comprehensive.

- *Federal Legislation Impact:* H.R. 1 amended section 61(a) of the Internal Revenue Code regarding a reference to a repealed deduction for alimony payments.¹⁰ This amendment does not directly impact the calculation of the new section 199A deduction.¹¹

B. Adjusted Gross Income Calculation

After determining gross income, the next step in calculating Montana income tax is to calculate Montana adjusted gross income. Pursuant to section [15-30-2110](#), MCA, except as otherwise provided "adjusted gross income is the taxpayer's federal adjusted gross income as defined in section 62 of the Internal Revenue Code, 26 U.S.C. 62". Section 62(a) of the Internal Revenue Code, in turn, defines adjusted gross income (AGI) as gross income minus certain specific deductions, most of which contain restrictions that are detailed in other code sections. The deductions listed in section 62 of the Internal Revenue Code are often referred to as "above the line" deductions. Individual taxpayers are allowed to deduct above the line deductions, regardless of whether they itemize or claim the standard deduction. Consequently, decisions of Congress can have a direct impact on Montana AGI. However, there are multiple items that are specifically included and excluded (*i.e.*, additions and subtractions) in Montana AGI regardless of what Congress does. The Legislature frequently amends section [15-30-2110](#), MCA, to deviate from and supplement the federal definition of AGI.

- *Federal Legislation Impact:* H.R. 1 amended section 62 of the Internal Revenue Code in multiple places. One of the impacts of the amendments to this code section is to ensure that a taxpayer claims the new section 199A deduction as an independent deduction that is not associated with the calculation of federal AGI. Given that federal AGI is not impacted by the deduction, Montana AGI is not impacted. The Department's internal memorandum similarly concludes that the new section 199A deduction cannot be used as

⁹ *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 429 (1955).

¹⁰ Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11051, p. 36 ("Subsection (a) of section 61 is amended by striking paragraph (8) and by redesignating paragraphs (9) through (15) as paragraphs (8) through (14), respectively.")

¹¹ Section 199A contains limits that are tied to taxable income. Given that H.R. 1 eliminates the alimony deduction for certain spouses that pay alimony, there is an indirect impact from this amendment at the federal level.

an above the line deduction.¹²

C. Itemized vs. Standard Deduction

Similar to the federal income tax, Montana allows taxpayers to choose between itemized deductions or a standard deduction. Generally Montana income tax will be less if a taxpayer takes the larger of the itemized deductions or the standard deduction.

The determination of what is allowed for purposes of claiming itemized deductions starts out with a reference to the federal tax code. Pursuant to section [15-30-2131](#), MCA, the items referred to in sections 161 and 211 of the Internal Revenue Code are deductible, with some exceptions. Additionally, similar to the calculation of Montana AGI, taxpayers are prohibited from taking certain deductions and allowed to take others regardless of what Congress does. The Legislature has not amended section [15-30-2131](#), MCA, since 2005.

A taxpayer who does not itemize is allowed to claim a Montana standard deduction. Unlike the Montana itemized deduction, the standard deduction is not tied to federal law and congressional changes do not impact it. Pursuant to section [15-30-2132](#), MCA, the minimum standard deduction is the greater of \$1,980 (plus a statutory adjustment for inflation) or 20% of Montana AGI and the maximum standard deduction is \$4,460 (plus a statutory adjustment for inflation). Taking the inflation factor¹³ into account, the maximum standard deduction was \$4,370, \$4,460 and \$4,510 for tax years [2015](#), [2016](#), [2017](#), respectively.

- *Federal Legislation Impact:* H.R. 1 amended sections 62 and 63 of the Internal Revenue Code in multiple places to ensure that the new section 199A deduction is an independent deduction on a federal income tax return that is not associated with the calculation of federal AGI, federal itemized deductions, or the federal standard deduction. In other words, a taxpayer can elect to claim federal itemized deductions or the federal standard deduction. Presumably one of the policy decisions of allowing taxpayers to claim the section 199A deduction as a stand alone federal deduction is to encourage more taxpayers to claim the higher federal standard deduction, which in turn would lower the amount of taxpayers that would claim federal itemized deductions.
- The Department's internal memorandum concludes that the new section 199A deduction can be claimed as an itemized deduction on a Montana income tax return, even though it

¹² Department of Revenue Internal Memorandum, p. 2 (reasoning that "IRC § 199A is specifically excluded as an above the line deduction" for state tax purposes).

¹³ Pursuant to section [15-30-2101](#), MCA, inflation factor "means a number determined for each tax year by dividing the consumer price index for June of the previous tax year by the consumer price index for June 2015."

cannot be claimed as an itemized deduction on a federal return.¹⁴ Given the complexity of this issue, part 3 of the analysis addresses this interpretation. Ultimately, I would not recommend that a taxpayer claim a section 199A deduction on a Montana return as an itemized deduction unless the Department formally adopts this approach.

D. Montana Personal Exemptions

Similar to the federal income tax (prior to H.R. 1), Montana allows taxpayers to claim personal exemptions.¹⁵ The Montana personal exemption is not tied to federal law and it exists irrespective of what Congress does. Pursuant to section [15-30-2114](#), MCA, the personal exemption is adjusted for inflation and is calculated by multiplying the dollar amount of the exemption by the number of exemptions (*i.e.*, taxpayer, spouse, children, dependents, additional exemption for age 65 and above, additional exemption for blind). Taking the inflation factor into account, each personal exemption was \$2,330, \$2,380, and \$2,400 for tax years [2015](#), [2016](#), [2017](#), respectively.

- *Federal Legislation Impact:* H.R. 1 amended the federal statute regarding personal exemptions by an amendment that states "The term 'exemption amount' means zero" for tax years 2018 through 2025.¹⁶ The Montana Code Annotated does not adopt the federal personal exemption statute, so a personal exemption is still available on a Montana return.

E. Calculate Montana Taxable Income

Pursuant to section [15-30-2101](#), MCA, Montana taxable income "means the adjusted gross income of a taxpayer less the deductions and exemptions provided for" under the Montana tax code. As such, taxable income is calculated using Montana AGI, the higher of itemized deductions or the standard deduction (assuming a taxpayer elects to use the higher of the two), and allowable personal exemptions.

F. The Last Step -- Montana Tax Calculation.

Montana uses a single rate structure for all taxpayers, regardless of filing status.¹⁷ The rate structure is modified by the Department on a yearly basis by the inflation factor for the tax year,

¹⁴ Department of Revenue Internal Memorandum, p. 3 (reasoning "new IRC § 199A is an item of deduction available to offset QBI from pass-through entities to itemized individual income tax returns in Montana").

¹⁵ Section 151 of the Internal Revenue Code; Section [15-30-2114](#), MCA.

¹⁶ Section 151 of the Internal Revenue Code, as amended by the Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11041, p. 29.

¹⁷ See section [15-30-2103](#), MCA.

as rounded to the nearest \$100.¹⁸ Montana's rate structure is progressive, since taxpayers with higher incomes pay a higher percentage of their income in tax. However, unlike the federal brackets Montana's rates max out at a fairly low level of taxable income. The easiest way to calculate total Montana tax is to use the rate tables published by the Department. These tables have already taken into account the progressive rates of tax and the inflation factor.

3. THERE ARE REASONABLE GROUNDS FOR A COURT TO CONCLUDE THAT THE NEWLY CREATED SECTION 199A DEDUCTION IS NOT AVAILABLE AS A MONTANA ITEMIZED DEDUCTION

H.R. 1 amended sections 62 and 63 of the Internal Revenue Code in multiple places.¹⁹ The overall impact of the amendments to these code sections ensure that a taxpayer filing a federal return may claim the new section 199A deduction as an independent deduction that is not associated with the calculation of federal AGI, federal itemized deductions, or the federal standard deduction. In other words, federal AGI is not impacted by the deduction and a taxpayer can elect to claim federal itemized deductions or the federal standard deduction. Presumably one of the policy decisions to allow taxpayers to claim the section 199A deduction as a stand-alone deduction is to encourage more taxpayers to claim the higher federal standard deduction, which in turn would lower the amount of taxpayers that would claim federal itemized deductions. Consequently, treating the section 199A deduction as a Montana itemized deduction is a major deviation from the federal system.

Subpart 3.A. starts with an overview of the legal standard that the Department must satisfy when analyzing a Montana income tax statute. Subpart 3.B. reviews past practices in state taxation and the administration of itemized deductions to conclude that reasonable arguments can be made for Montana to follow the federal definition of "itemized deductions" for the purpose of determining that the new section 199A deduction is not a Montana itemized deduction. Subpart 3.C. reviews additional statutory language in the Montana itemized deduction code section to formulate an argument that Montana should not allow state itemized deductions when itemized deductions are not allowed on a federal return. And finally, subpart 3.D concludes that treating section 199A as an itemized deduction could result in the statute being applied in a manner that results in unlawful delegation of legislative authority.

A. Department's Internal Memorandum and Overview of Standard.

The purpose of this memorandum is not to disagree with the logic of the Department's internal memo, which represents the types of arguments that the Department could expect in the event the section 199A deduction is formally disallowed by the Department. Instead of disagreeing with

¹⁸ *Id.* Montana's initial inflation factor was enacted by initiative in 1980. Sec. 2, I.M. No. 86, approved Nov. 4, 1980.

¹⁹ Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11011, p. 17.

the internal memo, this memorandum applies the legal standard that a court would apply to conclude that there are other reasonable interpretations. The Montana Supreme Court provided that the standard is as follows:

"When the Department has only the language of the Montana revenue code on which to base its interpretation of a specific code section, we will not disagree with the Department's interpretation if that interpretation is reasonable."²⁰

In other words, the focus of this part is to provide other arguments that could be asserted in defending the position that the state of Montana did not adopt the new section 199A deduction through the statutory language of section [15-30-2131](#), MCA. Ultimately, the fact that multiple arguments can be made for and against treating the newly enacted section 199A deduction as a state itemized deduction shows that the Legislature may desire to clarify at some point in the future whether this exemption is available.

B. Past Practice Shows that the Department Already Relies on the Federal Definition for Itemized Deductions

This subpart reviews the position in the Department's internal memorandum and does not restate all the issues in that memo. As such, it is helpful to read the Department's internal memo prior to reading this subpart.

The determination of what is allowed for purposes of claiming state itemized deductions starts out with a reference to the federal tax code. Section [15-30-2131](#), MCA, provides:

15-30-2131. Deductions allowed in computing net income. (1) In computing net income, *there are allowed as deductions:*

(a) *the items referred to in sections 161, including the contributions referred to in 33-15-201(5)(b), and 211 of the Internal Revenue Code, 26 U.S.C. 161 and 211, subject to the following exceptions, which are not deductible: . . . (emphasis added)*

Section 161 of the Internal Revenue Code, in turn, provides:

Allowance of deductions. In computing taxable income under section 63, *there shall be allowed as deductions the items specified in this part [i.e., Part VI of Subchapter B, Chapter 1, Subtitle A], subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible). (emphasis added)*

²⁰ *Baitis v. Dep't of Revenue*, 2004 MT 17, ¶ 24, 319 Mont. 292, 83 P.3d 1278.

The Department's internal memorandum relies on the interplay of section [15-30-2131](#), MCA, and section 161 of the Internal Revenue Code in determining that the "plain language of Montana law permits the deduction of QBI [*i.e.*, section 199A] for taxpayers who itemize deductions against Montana income."²¹ As I understand the memo, the reasoning is based on a portion of the above italicized language of section 161 of the Internal Revenue Code, which allows deductions to the items specified in Part VI of Subchapter B, Chapter 1, Subtitle A of the Internal Revenue Code. In other words, the position is that section 199A is a deduction in calculating Montana net income based on the fact that it is codified in the same part of the Internal Revenue Code that is adopted in the Montana Code Annotated. The fact that the Internal Revenue Code also prohibits a federal taxpayer from claiming the section 199A deduction as an itemized deduction is not a determining factor in the memorandum, as Congress did not codify the prohibition in the part that is adopted by reference (*i.e.*, part VI).²² The conclusion in the memo is driven by the fact that other states take a different approach than Montana by adopting the federal definition of "itemized deductions" in section 63 of the Internal Revenue Code, which provides for all allowable deductions, except for the deductions allowable in arriving at adjusted gross income, personal exemptions, and now the newly enacted section 199A deduction.

As a matter of background, the Internal Revenue Code is organized by Subtitle, Chapter, Subchapter, and Part. When language from the Internal Revenue Code cites to "this part", the reference is to the same Subtitle, Chapter, and Subchapter where the reference to "this part" appears. As applied here, the part that is incorporated by reference in section [15-30-2131](#), MCA, is labeled "[Itemized Deductions for Individuals and Corporations](#)", which encompasses sections 161 through newly enacted 199A of the Internal Revenue Code. As such, a variety of federal itemized deductions are codified in this part. The subchapter where this part located is labeled "[Computation of Taxable Income](#)", which encompasses sections 61 through 291 of the Internal Revenue Code.

[Sections 61 through 68 of the Internal Revenue Code](#) set out important foundational concepts for the federal income tax. As discussed earlier in this memo, Montana relies on the federal definition of gross income²³ and adjusted gross income²⁴ to set the foundation. Montana did not adopt the comprehensive federal definition of "itemized deductions" in section 63 of the Internal Revenue Code, which before H.R. 1 provide for all allowable deductions²⁵, except for the

²¹ Department of Revenue Internal Memorandum, p. 3 (last paragraph).

²² Department of Revenue Internal Memorandum, p. 3.

²³ Section 61 of the Internal Revenue Code; section [15-30-2101](#), MCA.

²⁴ Section 62 of the Internal Revenue Code; section [15-30-2110](#), MCA.

²⁵ Section 63 of the Internal Revenue Code permits a federal taxpayer to pick between the standard deduction or itemized deductions, but does not allow a taxpayer to claim both.

deductions allowable in arriving at adjusted gross income and personal exemptions. Instead, Montana limited the federal definition of itemized deductions by requiring the state itemized deductions to be in specific parts of the Internal Revenue Code. At the time of enactment, this approach was more restrictive than citing to the broader term in section 63 of the Internal Revenue Code.

As applied here, the fact that Montana itemized deductions are provided for in a section outside of the foundational sections 61 through 68 does not necessarily mean these code sections do not have a bearing on Montana itemized deductions. As one prime example, section 68 of the Internal Revenue Code limits the amount of allowable federal "itemized deductions" that a taxpayer can take for certain higher income taxpayers.²⁶ In order to limit the deduction, section 68 relies on the federal term "itemized deductions"²⁷, which again, is not directly adopted in the Montana Code Annotated. Nonetheless, Montana applies an income-based limit at the state level by lowering the amount of state itemized deduction a taxpayer may claim for certain higher income taxpayers.²⁸ This calculation can be found on the [2017 Schedule III](#) – Montana Itemized Deductions (line 30), on the [2017 Worksheet VI-IDL](#) – Itemized Deduction Limitation, and is further defined in Montana Administrative Rule [42.15.425](#) (reasoning that "when the deductions allowed under [15-30-2131](#), MCA, are limited to a percent of adjusted gross income by reference to the IRC, Montana adjusted gross income must be used when calculating the deductions limitation for the Montana return").

As another example, [section 67](#) of the Internal Revenue Code limits the amount of allowable federal "miscellaneous itemized deductions" that a taxpayer can take "to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income."²⁹ In order to limit the deduction, section 67 modifies the federal term "itemized deductions"³⁰, which, again, is not

²⁶ Section 68 of the Internal Revenue Code was amended by H.R. 1 by suspending the overall limitation on itemized deductions for tax years 2018 through 2025. Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11046, p. 35.

²⁷ Section 68(c) of the Internal Revenue Code relies on the term "itemized deductions" from section 63(d) of the Internal Revenue Code, but it modifies it further by stating that for the purpose of the reduction statute, the term does not include: "(1) the deduction under section 213 (relating to medical, etc. expenses), (2) any deduction for investment interest (as defined in section 163(d)), and (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d)."

²⁸ This reduction occurs, despite the fact that section 68 of the Internal Revenue Code is not incorporated in the Montana Code Annotated, and despite the fact that some of the items that are reduced are incorporated through section [15-30-2131](#), MCA.

²⁹ Section 67 of the Internal Revenue Code was amended by H.R. 1 by suspending the ability of a taxpayer to claim miscellaneous itemized deductions for tax years 2018 through 2025. Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11045, p. 35.

³⁰ Section 67(b) of the Internal Revenue Code relies on the term "itemized deductions" from section 63(d) of the Internal Revenue Code by defining miscellaneous itemized deductions as all "itemized deductions" other than the following:

directly adopted in the Montana Code Annotated. Nonetheless, Montana applies the 2 percent calculation at the state level by lowering the amount of state "miscellaneous itemized deductions" a taxpayer may claim.³¹ This calculation can be found on the [2017 Schedule III](#) – Montana Itemized Deductions (line 25).

In short, Montana appears to have a history of relying on the federal definition for "itemized deductions" when applying limitations to Montana itemized deductions, despite the reasoning in the internal memorandum that Montana should not rely on this federal definition. This historic approach is defensible, as section [15-30-2620](#)(2), MCA, provides that if a term is not defined in the Montana individual income tax code, "the term has the same meaning as it does when used in a comparable context in the Internal Revenue Code".

Similar to past practice, there appears to be reasonable grounds to deny a section 199A deduction on a Montana return. This is the case, as section 63(d) of the Internal Revenue Code as amended by H.R.1 specifically states that for the purposes of [subtitle A](#) (*i.e.*, the federal income tax) "the term 'itemized deductions' means the deductions allowable under this chapter³² *other than*—

- (1) the deductions allowable in arriving at adjusted gross income,

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- "(1) the deduction under section 163 (relating to interest),
 - (2) the deduction under section 164 (relating to taxes),
 - (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
 - (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),
 - (5) the deduction under section 213 (relating to medical, dental, etc., expenses),
 - (6) any deduction allowable for impairment-related work expenses,
 - (7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),
 - (8) any deduction allowable in connection with personal property used in a short sale,
 - (9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),
 - (10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),
 - (11) the deduction under section 171 (relating to deduction for amortizable bond premium), and
 - (12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations)."

³¹ This reduction to a deduction occurs, despite the fact that section 67 of the Internal Revenue Code is not incorporated in the Montana Code Annotated, and despite the fact that items that are reduced are incorporated through section [15-30-2131](#), MCA. *See also* [2016 Montana Form 2 with MCA and ARM Citations](#), Schedule III – Montana Itemized Deductions (line 25) (citing [ARM 42.15.525](#) as the source for the 2 percent calculation).

³² [Chapter 1 of subtitle A](#) is entitled "normal taxes and surtaxes", which includes the federal individual income tax.

- (2) the deduction for personal exemptions provided by section 151, and,
- (3) *the deduction provided in section 199A.*³³

As discussed in the Department's internal memorandum and a good portion of this memo, Montana does not expressly adopt section 63(d) of the Internal Revenue Code. Montana's approach is to adopt specific parts of the Internal Revenue Code that contain the bulk of federal itemized deductions, which happen to include the new section 199A deduction. This leads to the conclusion in the Department's internal memorandum that new section 199A is a Montana itemized deduction, which effectively ends the analysis. Yet, the amendment to section 63(d) applies to the entire federal income tax code, including the parts of the federal income tax code adopted by Montana law. By applying section [15-30-2620\(2\)](#), MCA, the Department could conclude that the federal definition for "itemized deductions" in section 63(d) of the Internal Revenue Code, which disallows the new section 199A deduction, can also be applied to deny it as a Montana itemized deduction. Indeed, a section 199A deduction will not appear as an itemized deduction on the 2018 federal income tax return.

C. Additional Statutory Language Supports a Reasonable Argument That the Legislature Did not Intend to Allow State Itemized Deductions When Itemized Deductions Are Not Allowed on a Federal Return.

A tie to the federal system lowers the Department's costs of administering the income tax while simultaneously lowering a taxpayers' costs of complying.³⁴ Allowing federal deductions to be claimed on a state return regardless of whether they are allowed on a federal return does not satisfy this goal.³⁵ In denying the section 199A deduction as a state itemized deduction, the Department could look at additional language in section 161 of the Internal Revenue Code. Section [15-30-2131](#), MCA, provides: "In computing net income, there are allowed as deductions . . . the items referred to in sections 161 . . . of the Internal Revenue Code"

Section 161 of the Internal Revenue Code, in turn, provides:

Allowance of deductions. *In computing taxable income under section 63, there shall be allowed as deductions the items specified in this part [i.e., Part VI of Subchapter B, Chapter 1, Subtitle A],*

³³ Section 63(d) of the Internal Revenue Code, as amended by the Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11011, p. 17 (emphasis added).

³⁴ Montana Department of Revenue, [Biennial Report: July 1, 2008 – June 30, 2010](#), p. 54 (2010).

³⁵ On occasion Montana adopts portions of the Internal Revenue Code that are not followed at the federal level. However, the manner in which the adoption occurs is express. For example, in section [15-30-2131\(1\)\(d\)](#), MCA, the Montana Legislature made a policy decision to allow political contributions that were allowable under a provision of the Internal Revenue Code that has since been repealed.

subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible). (emphasis added)

An important question is whether the above italicized language that references section 63 of the Internal Revenue Code is relevant. The Legislature clearly intended to allow deductions in part VI, but does this mean all deductions in this part are automatically Montana itemized deductions? If the federal government were to eliminate all the deductions to part VI through another part of the federal income tax code by stating that all the deductions in part VI do not exist, would Montana still be required to allow the deductions in part VI? Or does Montana also look to the other language in section 161, which would require the deduction to be utilized for the calculation of federal income tax before the item can be considered for Montana income tax purposes. There is a clear statutory link at the federal level between sections 63 and 161 of the Internal Revenue Code. If the italicized language is relevant to interpreting Montana's approach to calculating itemized deductions, then the H.R. 1 amendment to section 63(d) that prevents a section 199A deduction from being a federal itemized deduction is particularly relevant. Looking at this statutory structure, one reasonable argument is that the state does not adopt federal itemized deductions in parts VI and VII when they are not available at the federal level.³⁶ Consequently, a section 199A deduction would not be available as a state itemized deduction.

D. Deductions Are a Matter of Legislative Grace -- Delegation of Legislative Power

There is a fundamental question of whether the Legislature intended to allow taxpayers to claim a deduction that was impossible for the Legislature to contemplate. In general, tax deductions are a matter of legislative grace and a taxpayer must clearly demonstrate the right to a claimed deduction. *Robison v. Mont. Dep't of Revenue*, 2012 MT 145, ¶ 12, 365 Mont. 336, 340, 281 P.3d 218, 222; *Baitis v. Department of Revenue*, 2004 MT 17, ¶ 28, 319 Mont. 292, 83 P.3d 1278. In order to firm up this concept, the Legislature provided in section [15-30-2102](#), MCA, that "*all income except what has been expressly exempted under the provisions of this chapter [i.e., Montana Individual Income Tax] and income not permitted to be taxed under the constitution of this state or the constitution or laws of the United States shall be included and considered in determining the net income of taxpayers within the provision of this chapter.*" (emphasis added). The analysis of whether Montana expressly exempted the new section 199A deduction is complex, and a taxpayer that desires to claim such a deduction would need to clearly demonstrate that the statute allows it. Given the complexity involved and the arguments that can be put forward, I would not recommend that a taxpayer claim the deduction without an official adoption of the approach by the Department.

³⁶ This is particularly relevant, as H.R. 1 suspended the deductibility of federal miscellaneous deductions in section 67 of the Internal Revenue Code. See Tax Cuts and Jobs Act, [Public Law No. 115-97](#), § 11045, p. 35 (Section 67 was amended by adding: "Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026."). The suspended items cannot be deducted at the federal level and they do not reduce federal taxable income. However, the items that are suspended are some of the same items that are adopted by section [15-30-2131](#), MCA. Legislative staff is currently researching this potential issue.

Moreover, there is a critical questions as to whether a court would even need to analyze the statutory text in great detail. Instead of spending time circling around the Internal Revenue Code and the state tax code, a court could reason that treating section 199A as an itemized deduction results in the statute being applied in a manner that results unlawful delegation of legislative authority. As an example, *Lee v. State of Montana*³⁷, is a case in which a motorist challenged the 55 m.p.h. speed limit. To continue to receive federal highway funding, the Legislature provided that if Congress required a speed limit the Attorney General "shall" by proclamation adopt a speed limit and "shall" make further proclamations if federal law was changed. The Montana Supreme Court held that the proclamation powers were an unconstitutional delegation of legislative authority to the Attorney General. Because of the mandatory directions to the Attorney General, the Court said, "[a] more blatant handover of the sovereign power of this state to the federal jurisdiction is beyond our ken."³⁸ As applied here, the Court could likewise find that adopting a newly minted income tax deduction that has a large negative fiscal impact is an unconstitutional delegation of legislative authority. In fact, the adoption of a section 199A deduction is arguably more of a "handover" than the one in *Lee*, as the concept was just enacted by Congress and the Legislature did not have the opportunity to debate it, let alone enact it.³⁹

CONCLUSION

Ultimately there are a variety of reasonable arguments regarding why the section 199A deduction should not be treated as a state itemized deduction. As such, I would not recommend that a taxpayer claim the new section 199A deduction as a state itemized deduction without formal adoption of the concept by the Department through the administrative rulemaking process.

One way to clear up this matter would be through legislation that is drafted in a manner that is similar to how other states adopt the federal definition of "itemized deductions", or through a specific disallowance of the section 199A deduction in section [15-30-2131](#), MCA.

³⁷ *Lee v. State*, 195 Mont. 1, 635 P.2d 1282 (1981).

³⁸ *Id.* at 9.

³⁹ A few states have sidestepped the potential problem of unconstitutional delegation of legislative powers by determining that a state tax enacted by the legislature can use changing federal law for the computation of the amount payable to the state because the legislature determines whether the tax exists or will continue to exist and the tax is not established independent of the state's legislative action. *See In re Estate of West*, 226 Neb. 813, 415 N.W.2d 769 (1987). Similar arguments could be utilized to defend Montana's existing structure of taxation when federal changes pertain to computational matters, or perhaps even matters revolving around the timing of deductions to ensure that the federal return and Montana return are comparable. The section 199A deduction is much broader.

I hope that I adequately addressed your question. If you have any further questions, do not hesitate to contact me.

Sincerely,

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