Problems encountered in Montana income tax receipts as a result of the 1955 transition to federal adjusted gross income

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PROBLEMS ENCOUNTERED IN MONTANA INCOME TAX RECEIPTS
AS A RESULT OF THE 1955 TRANSITION TO
FEDERAL ADJUSTED GROSS INCOME

by

JAMES MADISON

B.S. Montana State University, 1955

Presented in partial fulfillment of the requirements for the degree of

Master of Science in Business Administration

MONTANA STATE UNIVERSITY

1960

Approved by:

[Signatures]

Chairman, Board of Examiners
Dean, Graduate School

AUG 18 1960
Date
As an aid to the reader the opening paragraphs of this paper give a brief history of the Montana Income Tax Law and a summary of the reasons why the transition to federal adjusted gross income was considered necessary.

Part I outlines the major problem areas caused by the 1955 transition to federal adjusted gross income and also considers the specific causes of losses or gains in revenue due to the transition. These problems were most pressing in 1955, 1956, and 1957; some of them, however, are still present and troublesome. The solutions recommended for each of these by the Montana Income Tax Department are explained. Such solutions are not in every case accepted as correct by all groups and such acceptance is not implied.

Part II examines the Montana State Income Tax Law in an effort to determine whether it provides a truly progressive tax. Two changes in the law are suggested. Since one of these is a major change with far reaching results, its possible effects on other areas are analysed.

Appendix A contains a brief description and analysis of the method used to determine whether or not the Montana income tax is a progressive tax.

Appendix B includes the statistical formulas used to determine the reliability of the sample which was the basis for forecasting the effects of the change in the law recommended in Part II.
The reader should keep in mind the fact that this is a primary source paper. Source material was, of course, Montana State Income Tax Returns. Although returns for the year 1958 were used somewhat more than those for any other year, in a way the information presented represents a summary of the returns for all years starting with 1933. The opinions stated and the conclusions reached in this paper are my own. All of the historical information I obtained while an employee of the Montana State Board of Equalization; the idea of using this information for further research resulted from my work with the actual returns and from discussions with other Board employees, taxpayers, accountants, and attorneys.

I wish to thank all of the people who helped make this paper possible either by furnishing ideas or by helping in its preparation. In particular, I wish to express appreciation to Mr. J. L. Lorenzen, Supervisor, State Income Tax Department, Audit Division, for furnishing historical information and the stimulation for further research; to Mr. L. M. Brewer, Supervisor, State Income Tax Department, for furnishing statistical information regarding the Montana returns and the opportunity for me to obtain a sample of the 1958 Montana returns; to Mr. Fred Harris, Instructor, School of Business Administration, Montana State University, for his help in setting up and explaining the statistical formulas used in Appendix B; and to Dr. D. J. Emblen and Dr. Jack J. Kempner, Professors, School of Business Administration, Montana State University, who offered constructive criticism.
and suggestions before final copy of this paper had been prepared. To all of the other contributors not mentioned by name, I wish also to express my sincere appreciation.
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PART I

CHAPTER I

PROBLEM AREAS

During the early months of 1955 the Montana Legislative Assembly made an almost complete revision of the Montana Income Tax Law. The most important change was in the definitions of adjusted gross income and allowable deductions. For all taxable years ending on or after December 31, 1955, adjusted gross income for state income tax purposes is now the taxpayer's adjusted gross income as defined in Section 62 of the Internal Revenue Code of 1954, or as that section shall be labeled or amended; in addition it includes interest on all state, county, and municipal bonds, but does not include interest on United States obligations or dividends received from national banks whose situs is in Montana. Allowable deductions are defined as the items referred to in Sections 161 and 211 of the Internal Revenue Code of 1954 or as these sections shall be labeled or amended. There are two exceptions to this definition of allowable deductions: state income tax paid is not deductible, but federal income tax paid within the taxable year is an additional allowable deduction. One other major change in the law, the section providing for the withholding of Montana income tax by employers, is outside the province of this paper.
The first state income tax law became effective January 1, 1933. It was originally passed to supplement the greatly reduced receipts from the property tax during the depression. Like many taxes which are imposed for a supposedly temporary emergency period, it has never been repealed; the State of Montana became dependent on the money it provided. Montana's Income Tax Law was patterned after the income tax laws of New York and California. From 1933 to 1955 a substantial number of changes were proposed, many of which were incorporated into the law in the form of amendments. The first major revision, however, was the 1955 transition to federal adjusted gross income.

In order to understand why this change was considered necessary it is important to examine closely the law itself. When the law was drawn up there was a deliberate attempt to make each year, and in fact each transaction, "stand on its own." For example, there was no provision for carryover or carryback of net operating losses. Further, when a taxpayer traded in an old fixed asset on a new one he was required to record two separate transactions; he was not allowed to adjust the cost basis of the new asset for any gain or loss on the old asset. This procedure was possible because the tax rates were so low (the maximum rate was 4%), that the amount of tax due was not very large even when taxable income was in the five digit range. In many ways the original Montana law followed generally accepted accounting principles much more closely than the present Internal Revenue Code. These differences between Montana law and Federal law placed a burden on the
taxpayers since they made it necessary to keep at least two sets of records for many items.* They also placed a burden on the State Income Tax Department because they necessitated a detailed office audit by experienced personnel of every Montana return. These differences between the federal and state laws also created the problems when Montana shifted to federal adjusted gross income. Let us now consider the major areas in which these problems developed.

The Montana Income Tax Law had never provided for the reporting of gains from casual sales of personal property on the installment basis. Instead it had insisted that gains or losses from such sales must be reported in full for the year in which the sale took place. Thus if for 1955 or later years federal adjusted gross income included a gain reported on the installment basis from a casual sale of personal property which had taken place prior to January 1, 1955, this gain had to be deleted in the computation of Montana adjusted gross income. The actual subtraction itself, of course, presented no problem. The difficulty was encountered because the state income tax return provided no place for an explanation of the subtraction from federal adjusted gross income and very few taxpayers attached the requested explanatory schedules. It was usually necessary first to send a letter to the taxpayer requesting a detailed explanation for the subtraction,

*This statement does not imply that a majority of Montana's taxpayers now maintain their accounting records according to tax law but merely that at least two sets of records were required when Montana and federal definitions of income were different. Even today with both definitions of income the same many taxpayers maintain two sets of records, one according to generally accepted accounting principles and another according to tax law.
and secondly to make a detailed audit of the return on which the sale was reported. Since such a procedure is very time consuming, even relatively few problems of this type hindered a smooth transition to federal adjusted gross income.

Probably the most difficult problem encountered in the transition period was explaining to taxpayers the correct procedure for carryback and carryover of net operating losses. As we have seen, the Montana Income Tax Law prior to 1955 attempted to make each year a separate unit. Thus a net operating loss which was sustained in any year was claimed in full for that year, no tax was paid, and the matter was closed. The next year was treated in the same manner and no shifting of loss between years was allowed.

When Montana adopted the federal definition of adjusted gross income the Internal Revenue Code provided for a two-year carryback and a five-year carryover of net operating losses. This has since been amended by the Technical Amendments Act of 1958 to provide for a three-year carryback. Three distinct types of problems were encountered in this area of net operating losses. The first type occurred where a net operating loss sustained in a year prior to 1955 had been carried over and was reflected in federal adjusted gross income for 1955 or a succeeding year. In this case it was only a matter of adding the amount of net operating loss carryover to federal adjusted gross income in order to arrive at Montana adjusted gross income. The second type, which was probably even easier to handle, involved a net operating loss for 1955 or 1956 which the taxpayer attempted to carryback to 1953 or 1954 by filing a claim for refund. Here the solution was merely
to disallow the claim for refund since Montana adjusted gross income was the same as the federally defined adjusted gross income only after January 1, 1955. The third type of problem was perhaps the hardest to explain and the most difficult for which to develop a workable solution. One example of this type would be a net operating loss for 1956 and net income in 1954 of a sufficient amount to absorb the carryback in full. In this case no refund could be issued for 1954 because it was before the effective date of the new law, and the loss could not be deducted in 1955 or years after 1956 because the procedure for handling net operating losses as set forth in the Internal Revenue Code had to be followed. There were many cases where a taxpayer, having learned that he could not claim a carryback or carryover loss for one year, attempted to claim it in another year. Such an attempt of course created chaos in the administration of this section of the new law, for it necessitated assembling returns for all of the years involved and the recomputation of allowable carryback and carryover net operating loss.

The next area to be considered is the carryover of capital losses. The problem here was that the Internal Revenue Code allowed only a very limited amount of capital loss to be deducted in any one year (a maximum of $1,000) but provided for a carryover into the five succeeding years for the nondeductible portion. Consequently federal adjusted gross income for 1955 through 1959 could reflect capital losses that were not deductible for state purposes in those years since a capital loss prior to 1955 should have been claimed in full for the year in which it occurred. Problems in this area caused far less
trouble than net operating losses, for the solution was simply to
add back to adjusted gross income the amount of the capital loss
which had been claimed. Of course the main problem was one of full
disclosure. If a taxpayer failed to mention that federal adjusted
gross income included a capital loss carryover from 1954 or a prior
year, the State Income Tax Department had no way of knowing it until
a copy of the federal return was examined.

Several problems all of a similar nature but having individual
characteristics developed in the depreciable asset field during the
1955 transition. Probably the most common problem dealt with the
correct basis for depreciating certain assets. Prior to 1955 the
Montana Income Tax Law had been interpreted to make every transaction
a gain or loss proposition whether or not a trade-in was involved. This
method could and did provide a much different depreciation base for
Montana purposes than the base used for federal purposes. With a dif­
ferent base, annual depreciation charges were quite naturally of
different amounts. For all practical purposes it was necessary to
ignore this type of problem during the change over to federal adjusted
gross income because of the huge number of returns which would be
involved and the number of detailed computations that would be necessary.
However, the State of Montana probably gained more than it lost by
ignoring the problem since the interpretation of the old law had never
been rigidly enforced and since the depreciation base for federal
purposes was typically less than for Montana purposes because of
excessive trade-in allowances on old assets.
Another related problem was the amortization of certain facilities over a sixty month period. The federal government had provided that grain storage facilities and certified "emergency facilities" (mainly assets used in the extraction and processing of ore) could be amortized over a sixty month period in lieu of normal depreciation over a longer period. The amortization period had no relationship to the life of the asset. The United States Congress had used its power to grant tax benefits as a method of stimulating a segment of the economy when it thought such stimulation was necessary for national defense and/or the general welfare. This procedure had never been allowed on the Montana returns. Quite possibly, therefore, the 1955 and later Montana returns did not reflect the full amount of deductible depreciation charges. This condition would develop where sixty month amortization of certain assets had been used on the federal returns prior to 1955 but of course not on the Montana returns. After 1955 the Montana return would reflect the same depreciation charge as the federal return unless an adjustment was made for the difference because of prior amortization. There are no records of such adjustments having been made. Here again it was impossible for the state's administrative agency to make the necessary changes. Undoubtedly Montana's income tax receipts were temporarily increased because of the amortization problem.

The old Montana law did not recognize depreciation of breeding stock whereas the Internal Revenue Code did. While this situation did not create a transition period problem in the depreciation account as did the sixty month amortization described above, it did create a
problem when the breeding stock was sold. Any depreciation that had been claimed on the federal return was added to the selling price of an animal when computing gain or loss on a sale. If an amount claimed prior to 1955 were included in the depreciation added to selling price, the gain computed for federal purposes would be considerably higher than the correct gain for state purposes. The following example should help to explain the problem. Assume that a rancher purchased a bull on January 1, 1952 for $700.00 and sold it on January 1, 1955 for $700.00. On his federal returns for 1952, 1953, and 1954 he would have claimed depreciation in the amount of $100.00 each year, or a total of $300.00 (using a normal seven year life for breeding stock). On his Montana returns for the same years he would have deducted nothing, since depreciation of breeding stock was not an allowable deduction. His 1955 Montana return under the old law would have recorded the transaction as follows:

<table>
<thead>
<tr>
<th>Per Federal Return</th>
<th>Per Montana Return</th>
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<tbody>
<tr>
<td>Selling price $700.00</td>
<td>$700.00</td>
</tr>
<tr>
<td>Add: depreciation allowed or allowable $300.00</td>
<td>none allowed</td>
</tr>
<tr>
<td>$1000.00</td>
<td>$700.00</td>
</tr>
<tr>
<td>Less: cost $700.00</td>
<td>$700.00</td>
</tr>
<tr>
<td>Gain $300.00</td>
<td>0.00</td>
</tr>
<tr>
<td>50% taxable $150.00</td>
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</tbody>
</table>

However, since Montana had adopted the definition of federal adjusted gross income, the 1955 Montana return reflected the $150.00 of taxable income.
In the area of personal residence sales no special treatment was provided under Montana's old law. Any gain was taxable in full but a loss could not be claimed. Here was another area in which each transaction was accounted for separately with no deferment of gains or losses. The problem of a different basis for federal and state purposes is minor here, however, for new residences are usually purchased within the recognized replacement period and in only a very few cases is it necessary to report gains from this type of sale. In the few cases that gains are reported, the federal basis is used. The use of the correct basis for Montana purposes would normally result in a smaller gain because property has evidenced an increase in value over a period of many years. Even when reporting the higher gain for Montana purposes, the taxpayer is not penalized, for he is taxed on only 50% of the gain.

Montana has always had trouble in obtaining state income tax returns from Montana residents serving on active duty in the military service. Prior to 1955 the problem was partially solved by a $200.00 a month exemption for such residents in addition to the regular personal exemption and other deductions. Because of this additional exemption most enlisted personnel had no Montana tax to pay. Even if at a later date they were asked to file a return there would be no tax, penalty, or interest due since the return would be nontax. After the new Montana law became effective the picture was changed a great deal; military pay became taxable in full for state as well as for federal purposes. The big difference was that federal tax is withheld from military pay while Montana tax is not. This problem has been very
serious and will continue to be so for a long time. When tax payments are requested from former servicemen a hardship is almost always created because of the penalty and interest that are due. No real solution to this problem has been found. Stating specifically in the instruction sheets which are mailed with the blank forms, that military pay is taxable is about all that can be done at present. Of course, the State Income Tax Department furnishes complete information to any of the military legal or personnel officers who request it for military publications or information centers.

Under Montana's old Income Tax Law the method of computing taxable portions of annuity payments (including social security benefits) was quite simple. Until cost had been recovered, all payments were tax free and after that taxable in full. This method was changed quite drastically when the new definition of adjusted gross income was adopted, and Montana suffered a consequent loss in revenue. The federal law requires a detailed computation based on life expectancy tables. Use of the federal formula generally results in a major portion of the payment being taxable income but under the old Montana law the entire payment, after recovery of cost, was taxable. The main loss was due not to the new method of computing the taxable portion of each payment but to the fact that social security payments were made nontaxable. Other types of annuity payments were a very minor item.

Now, as before the 1955 revision, there are three items for which treatment on the federal return differs from that required by Montana. Two items are taxable for federal purposes but not for state purposes and one item is taxable by Montana but not by the federal
government. Interest on U. S. Government obligations and dividends from a national bank located in Montana are taxable for federal purposes but not for state purposes. Therefore these items must be deducted when computing Montana adjusted gross income. The opposite treatment is necessary in the case of state, county, and municipal bond interest. These items created a problem during the transition period because most taxpayers considered Montana adjusted gross income to be the same as federal adjusted gross income and consequently made no adjustments for them.

A special type of problem during the transition period involved adjustments which were made by the Internal Revenue Service on a taxpayer's 1952, 1953, or 1954 federal return but which did not become known to the State of Montana until after the statute of limitations barred collections. This problem became especially bothersome when the adjustment dealt with deductions which the Internal Revenue Service treated as capital items subject to depreciation. On the Montana returns this treatment would have resulted in the items being claimed in full prior to 1955 and then deducted again after 1955 through annual depreciation charges. Such a situation could not be allowed. The taxpayer was given the choice of voluntarily paying the additional tax which would be due by making the same adjustments on the Montana returns as had been made on the federal returns or maintaining two sets of depreciation schedules. If the taxpayer chose the first alternative his federal adjusted gross income could be used as Montana adjusted gross income, but if he chose the second alternative the two would not be the same.
Because of the fact that federal income tax paid and/or withheld is an allowable deduction for state purposes, any refund of federal tax is taxable income by Montana in the year received. This rule held true under the old law just as it does under the new definition of adjusted gross income. The problem of getting refunds reported as income became greater during and after the 1955 transition because of the tendency on the part of the taxpayers, as mentioned before, to consider adjusted gross income on both returns to be the same. The problem is being met by placing more emphasis on this item in the instruction sheets and by obtaining information from the Internal Revenue Service as to the date and amount of the larger tax refunds which they issue.
CHAPTER 2

REVENUE LOSSES

The State of Montana reaped many benefits when it adopted the Internal Revenue Code's definition of adjusted gross income. These benefits will be discussed in the next section. However, any discussion of the 1955 transition which considered only the problem areas and the benefits without mentioning the cost of the transition would be one-sided. In particular two important sources of revenue were seriously affected by the 1955 transition. These two sources of revenue were capital gains and final returns of decedents. The loss of revenue from these sources was in addition to the losses or postponement of tax receipts in the problem areas discussed above, and much more serious.

In the case of capital gains there was a fifty per cent revenue loss. Since the amount of revenue from this individual item is not totaled separately at present nor was it prior to the 1955 transition, the exact amount of loss in dollars and cents cannot be given. Prior to 1955 all capital gains were taxed in full, but since the new definition of adjusted gross income only fifty per cent of capital gains are taxed. Probably the true seriousness of the loss involved cannot be grasped until the various types of sales treated as capital gains are enumerated. All assets used in a trade or business and held over six months are given capital gain treatment when they are sold. The same is true of stocks and bonds and all animals held for draft or breeding purposes. The number of taxpayers involved each year with this type of sale would run well into the thousands. Needless to say,
the loss of revenue could be conservatively estimated in six digit figures. Such a loss is a high price to pay merely for a new tax system.*

Another loss of revenue which was about half as great as that in the capital gain items occurred in final returns of decedents. Here again the loss could be estimated in six digit figures. Perhaps the best way to explain how the loss came about is to provide an example of how a final return of a decedent was prepared under the old law.

The types of taxpayers most affected were cash basis farmers, ranchers, and taxpayers holding installment sales contracts. Shortly after the date of death an appraisal of the deceased's assets was made. This appraisal was supposedly stated at the fair market value of all assets at date of death and was recorded on an inheritance tax form called an inventory and appraisal. Under Montana's old law the final return of a decedent was prepared for the fraction of a year (using whole months) from January 1, or the beginning date of a fiscal year to the date of death. An estate return was then filed for the remaining months in the taxable twelve-month period. In the case of farmers and ranchers with grain or livestock on hand at date of death these assets were reported in the final return as income in the amount recorded as the appraised value. In the case of livestock the value was apportioned over three years according to age of the animals at the date of the owner's death. Any increase in value which occurred after three years was considered as being due to market fluctuations. Even though no

*Since there is no way of proving or disproving any estimate, the reader may accept or reject the author's estimate of a $250,000 yearly loss.
sale had been made nor any cash received, this method of requiring the final return of a decedent to be prepared on an inventory basis was a fair and equitable tax system because the rate of tax was low (maximum four per cent) and because the costs of raising the grain or livestock had been deducted on a prior year's return or on the final (current) return. Also the tax basis of these assets to the heirs was the amount reported in the inventory and appraisal.

In the case of installment sales contracts, the amount of profit unreported at date of death was reported in the final return and the tax basis to the heirs became the amount of the contract remaining unpaid. There were of course cases in which the purchaser defaulted on his contract and repossession was necessary. No problem developed, however, since the heirs treated this in the same manner as any repossession and reported a gain or claimed a loss on the repossession. Their tax basis was usually somewhat higher than normal, but in all other respects the repossession was just like the procedure when an original seller takes back an asset which he has sold and for which he has received an installment sales contract.

At one time the Internal Revenue Code provided that final returns of decedents must be prepared on an inventory basis. This provision was later dropped when the rates were increased to their present range. It is easy to understand why a requirement that final returns of decedents be prepared on an inventory basis is unfair when rates become as high as those of the present federal income tax, for in the case of livestock or land which has been held over a long period of years, profits which have been accumulating over many years
are taxed at a very high rate in one year.

The Internal Revenue Service has made attempts to collect the revenue that is lost by not requiring the preparation of final returns of decedents on an inventory basis. One such attempt was a requirement that the executor or administrator post a bond to insure that the tax would be paid by the heirs. This procedure was too involved and was later dropped. In most cases the tax revenue from the profits on grain and livestock reported on a cash basis is now lost for both federal and state purposes because such profits are not reported in final returns of decedents.

During the years 1952, 1953, and 1954 unofficial totals of the tax collections made possible by the requirement that final returns of decedents be made on an inventory basis were kept. From these totals it was estimated that revenue from this one source would average about $10,000 per month. One hundred twenty thousand dollars a year is quite a serious loss to any state. It is particularly serious for the State of Montana since the income tax furnishes income for both the school funds and the general fund.
CHAPTER 3

REVENUE GAINS AND OTHER BENEFITS

After considering the two major losses of revenue in the preceding section and the minor losses which were discussed with the transition problems, the logical question to be raised is why the State of Montana adopted the definition of federal adjusted gross income. At this point it perhaps seems strange that the Montana State Board of Equalization passed on to the legislature the recommendation of its Income Tax Department that the Internal Revenue Code's definition of adjusted gross income and allowable deductions be incorporated into the State Income Tax Law. The reason, of course, was that the benefits and revenue gains were greater than the revenue losses and other problems.

When one examines the total collections from the individual income tax it appears that there was no loss of revenue because of the transition to federal adjusted gross income, for the total receipts have increased from the 1952-1953-1954 level. The loss has been sustained, nonetheless; it is hidden because of the fact that the number of returns filed has greatly increased. In 1952 the total number of returns filed was 167,728, whereas in 1958 the total had increased to 208,150. With an increase in the number of taxpayers filing returns the total receipts would quite naturally increase. This increase in the number of returns filed was one of the benefits planned when the transition to federal adjusted gross income was suggested by the Income Tax Department.

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Other benefits which were realized because of the transition included a fuller use of the I.B.M. equipment. Montana returns can now be filed on I.B.M. cards, and a detailed office audit by experienced personnel is no longer required for each return. Only the exceptions need such specialized treatment. Each return requires only a check on the computations and this recomputation can be made by any of the department's employees with the use of an adding machine. Very little time is required to train a large number of people who can perform the recomputation. Thus the Income Tax Department is able to capitalize on the audit of exceptions only. This statement, of course, does not imply that the department no longer has a tremendous number of returns to audit but merely that the number of returns that should be audited has been greatly reduced.

Since the federally defined adjusted gross income became, with a few adjustments, Montana adjusted gross income, a quite natural outcome was the development of a system to compare the amount reported on the federal return as adjusted gross income with that reported on the Montana return. This is accomplished by microfilming all of the federal returns and later reading selected information, including adjusted gross income, from the microfilm and punching it on I.B.M. cards. The information from the federal return can then be compared with the information on the Montana return with the use of I.B.M. equipment. Only the cards that do not agree are rejected by the I.B.M. machines. These rejected cards then require a complete examination by an auditor to find out why the two amounts do not agree. This system has two very important advantages. First, it provides the State of Montana...
with complete information on taxpayers filing federal returns but not Montana returns. There are other ways of obtaining information about delinquent taxpayers and these are still being used, but information from these other sources is not so complete as that yielded by a copy of the federal return, nor as easily obtained. Second, it permits the auditing of a majority of returns by I.B.M. machines rather than by office auditors. The big task of auditing the returns in the area of allowable deductions remains, but this type of audit deals mainly with amounts claimed which appear to be excessive.

By indexing the microfilm of federal returns, the Montana Income Tax Department has acquired complete information to supplement the condensed figures appearing on the Montana returns. These microfilms are referred to quite regularly, especially when federal and Montana adjusted gross income figures are not the same or when an unexplained addition or subtraction is made to the federal figure in arriving at Montana adjusted gross income.

Several other minor benefits were realized by the transition. One such benefit is the ease with which adjustments made on a taxpayer's federal return can be applied to his Montana return. Formerly a detailed computation was necessary in many cases before the adjustments could be applied to Montana returns. Another minor benefit is the comparative ease of preparing instruction sheets and explaining adjustments on a taxpayer's Montana return when none have been made on his federal return. It is no longer necessary to spell out in great detail what constitutes taxable income and allowable deductions.
Before leaving the subject of revenue gains, it seems necessary to point out that the increase in revenue is not due solely to the transition to federal adjusted gross income. A large part of this increase is the result of the withholding tax. Although a discussion of the withholding tax is outside the province of this paper, the benefits and increased revenue which it has provided must be taken into account. Since both the withholding tax law and the new definition of adjusted gross income became effective during 1955, it is impossible to determine the increased revenue and increased number of returns that each provided. A safe estimate would be to credit the withholding tax law with a major part of the additional returns and increased tax receipts.
The income tax has always been considered the fairest taxing system because it is based on ability to pay. There is always the possibility, however, that because of the definitions given taxable income or allowable deductions an income tax is not completely based on ability to pay. Each income tax law must be examined very closely to determine whether it provides for a progressive or regressive tax system.

A progressive tax is one which increases as the income increases and/or as the number of exemptions decreases. Since regressive contrasts with progressive and since there are no words to describe intermediate degrees, any tax which is not progressive is automatically regressive. Taxes which represent intermediate degrees are often said to have regressive characteristics. Such a distinction is so slight that it has been ignored in this paper.

Let us examine the Montana income tax system in order to determine whether it provides a progressive or regressive tax. The first point to notice is that for 1959 any taxable income over $7,000 was all taxed at five per cent. An income tax cannot be completely progressive unless it provides a higher rate as the taxable income increases. On this point alone, however, the Montana income tax could not be labeled regressive, since it is only a matter of degree as to how high the rates should go. That the Montana legislature decided to
set the highest rate at five per cent does not detract from
the fact that low incomes are taxed at a lower rate than high incomes,
nor does it cancel the principle that the more income a taxpayer earns
the more tax he pays.

The area of allowable deductions must also be considered. The
one item in this category that immediately draws attention is the
deduction for federal income tax. It is on this point that the
Montana income tax becomes a regressive tax. Because of this one
deduction, a single person pays less tax in the higher income brackets
than a husband and wife or than a married couple with one or more
dependents. In order to determine the exact income bracket at which
the regressive feature of the Montana income tax becomes evident, a
series of tables was prepared showing what the Montana tax would be
(using 1959 rates) for taxpayers with adjusted gross income from
$1,000 to $45,000 and with personal exemptions from one to seven. A
more complete discussion of how these tables were constructed and of
their limitations may be found in Appendix A.

An examination of these tables reveals that at the $12,000
adjusted gross income level a single person pays less Montana tax than
a husband and wife; at the $15,000 level less than a husband and wife
with one dependent; at the $18,000 level less than a husband and wife
with two dependents; at the $20,000 level less than a husband and wife
with three dependents; at the $22,000 level less than a husband and wife
with four dependents; and at the $24,000 level less than a husband and wife
with five dependents.

If anyone were attempting to defend the Montana income tax
against the regressive label which has been affixed to it in the above
paragraphs, he might point to the fact that since the majority of Montana returns report adjusted gross income of less than $12,000, it makes very little difference whether the system becomes regressive above $12,000. Such reasoning fails to take into account that the regressive characteristic is also present at the lower income levels, although it does not become evident until adjusted gross income reaches the $12,000 level. The fact that a single man pays more Montana tax than a husband and wife in the income brackets under $12,000 does not make the tax progressive. Down to the $4,000 level the difference between the tax that would be due in each case amounts to only a few dollars. This characteristic of a small difference also carries through into the tables where more personal exemptions are claimed.

Including federal income tax in the deductions which are allowed in computing Montana net income has the effect of making the State of Montana subsidize the federal government. The Montana income tax is an allowable deduction on the federal income tax return, and if the Montana tax became greater because federal income tax were not allowed as a deduction, the federal tax, in most cases, would be less because of the greater tax deduction.

There is also an inequality between residents of states that allow a deduction of federal income tax for state income tax purposes and those that do not. Taxpayers in the latter category pay less federal income tax than those in the former solely because of the deductibility of federal income tax.
CHAPTER 5

PROVIDING A PROGRESSIVE TAX

Having determined that the Montana income tax is a regressive tax and assuming that some future legislative assembly will choose to do something about this condition, let us examine the course of action that it could follow. The previous section has shown that the allowable deduction of federal income tax added the regressive characteristic to the Montana tax. This being so, the obvious solution to the problem is to remove federal income tax from the list of allowable deductions. Section 84-4906, Revised Codes of Montana, 1947, could be amended to delete paragraph (b) which adds to the deductions permitted by the Internal Revenue Code "federal income tax paid within the taxable year."

If such an amendment were passed and became law, two alternatives could be followed. First, the rest of the Income Tax Law could be left unchanged and the additional revenue would be distributed seventy-five per cent to the general fund and twenty-five per cent to the school equalization fund as is the case with all tax receipts from the personal income tax. Second, rates or personal exemptions could be adjusted so that total receipts would be approximately what they are at present. Since there seems to be a perpetual shortage of funds, the first alternative would undoubtedly be followed.

A sample of the 1958 Montana income tax returns was taken in order to get an indication of the effect of deleting federal income tax as a deduction. The method of obtaining this sample and procedures employed in determining its reliability are described in Appendix B.
A study of the sample indicates that if federal income tax were deleted from the list of allowable deductions and nothing else changed, total revenue from the personal income tax would be increased twenty-eight per cent. Since the mean of the sample is somewhat higher than the mean of the total population, a conservative estimate would be that total tax receipts would probably increase from fifteen to twenty per cent.

Such action by the legislature to delete the federal income tax deduction would also do away with the subsidy that the State of Montana pays to the federal government as discussed in the previous section. In addition, the inequality in federal tax payments existing between residents of Montana and residents of states such as California where federal income tax is non-deductible would disappear.

Any proposed change in the tax structure that would raise taxes is inevitably met with a storm of protest, and the change suggested above would doubtless receive the same treatment if it were considered by some future legislative assembly. Many of the taxpayers protesting, however, would be doing so for very little cause, as an examination of the classes of taxpayers affected will indicate. The following figures should help to illustrate the point that if federal income tax was not an allowable deduction the amount of Montana tax paid by a single taxpayer would be increased much more than the Montana tax paid by a married taxpayer with three dependents, thereby strengthening the progressive nature of the tax. Assuming average deductions, these tables compare the amount of Montana income tax that would be due under the present law, using 1959 rates, and the amount that would be due if the federal income tax were deleted as an allowable deduction.
SINGLE TAXPAYERS

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Present Tax</th>
<th>New Tax</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,000</td>
<td>$71.56</td>
<td>$94.00</td>
<td>31%</td>
</tr>
<tr>
<td>10,000</td>
<td>167.16</td>
<td>245.00</td>
<td>46%</td>
</tr>
<tr>
<td>20,000</td>
<td>424.40</td>
<td>745.00</td>
<td>75%</td>
</tr>
</tbody>
</table>

MARRIED TAXPAYERS WITH THREE DEPENDENTS

<table>
<thead>
<tr>
<th></th>
<th>Present Tax</th>
<th>New Tax</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>6,000</td>
<td>29.40</td>
<td>36.00</td>
<td>12%</td>
</tr>
<tr>
<td>10,000</td>
<td>109.10</td>
<td>135.00</td>
<td>25%</td>
</tr>
<tr>
<td>20,000</td>
<td>429.00</td>
<td>625.00</td>
<td>46%</td>
</tr>
</tbody>
</table>

Since the majority of returns reflect adjusted gross income of $6,000 or less, the estimate that total tax receipts would increase between fifteen and twenty per cent if the proposed change were adopted is further strengthened. In view of the fact that most returns report total income of less than $6,000, it would appear that the increase in the Montana tax for most taxpayers would be between $1.00 and $20.00. The above table also shows quite clearly the regressive feature of the present law by the much sharper increase in tax for single taxpayers.

In addition to providing a progressive income tax and increased revenue, the proposed change would provide many other benefits. The sample of 1958 Montana returns indicates that if federal income tax were not allowed as a deduction, sixty-four per cent (roughly two-thirds)
of all returns would claim a standard ten per cent deduction rather than itemized deductions. This would greatly reduce the task of preparing the returns by the taxpayers or their accountants; it would also reduce the number of returns requiring an audit by the State Income Tax Department. At present most taxpayers itemize deductions, since the federal tax alone is usually greater than a standard ten per cent deduction. The audit of deductions would thus be reduced from a possible 200,000 (plus) returns to a possible 70,000 returns. Of course not all returns are audited to determine whether excessive deductions are claimed, but the above figures do indicate the magnitude of the reduction in the audit workload.

Insuring that federal income tax refunds are reported as income in the year received has always been a difficult task for the Income Tax Department, both before and after the 1955 transition. It would cease to be a problem if the suggested amendment became law, since if federal income tax were not an allowable deduction, refunds would not be taxable income.
From 1933 to 1959 the Montana Income Tax Law had a reciprocity clause in the section dealing with tax credits for net income taxes paid to another state or country. The purpose of this reciprocal agreement was to grant tax credit on the Montana return of a non-resident in an amount that equaled the net income tax that he paid his state of residence on his Montana income. This reciprocity applied, of course, only in those cases where the other state would grant a similar credit to a Montana resident. As it turned out, the State of Montana ended up granting tax credit more times than it received it because of the trend for retired people to move to another state and take up residence there.

In 1959 the legislature amended Section 84-4937, Revised Codes of Montana, 1947, dealing with tax credits, so that effective with the calendar year 1959 tax credit for net income taxes paid to another state or country could be claimed only by residents of Montana. This was a much needed and long overdue amendment. However, it stopped one step short of providing a truly equitable tax credit section. The reason for this is that the word country was left in the section providing tax credit for "net income taxes imposed by and paid to another state or country." Inequality between a resident of this state having income from sources in another state and one having income from sources in another country is quite evident. Perhaps an example will best illustrate this point. Let us assume that one Montana resident
has income from Idaho sources of $1,000 and pays a net income tax to the State of Idaho of $40; another resident has income from Canadian sources of $1,000 and pays a net income tax to Canada in the amount of $300. Each of these residents would be allowed a tax credit of say $30 on his Montana return "for net income taxes imposed by and paid to another state or country." If the matter ended at this point there would be no inequality, but it does not, since the resident having income from Canadian sources is permitted to claim all or a major part of the $300 Canadian tax as a tax credit on his federal income tax return. Thus, the resident with income from Canadian sources is allowed a double tax credit, the total of both such credits often amounting to more than the tax he has actually paid to another country.

The only defense that can be offered for the above condition is that the number of Montana residents having income from Canadian sources is small and thus the double tax credit is not allowed more than a few times each year. Such reasoning, of course, does not justify the inequality that exists. If just one individual received the benefit of the double tax credit that would be sufficient reason for changing the law. Every time a double tax credit is allowed by the State of Montana all of the other Montana residents who receive income from sources in other states are not given fair and equitable treatment.

All that would be required to remedy this condition would be to delete the word country from the phrase in Section 84-4937, Revised Codes of Montana, 1947, which was quoted above. Probably the only reason this change was not made when the tax credit section was
amended in 1959 was that the members of the legislature were not aware of the unfair situation which the one word country brought about.
CHAPTER 7

SUMMARY

The Montana State Income Tax Department recommended the adoption of the federal definition of adjusted gross income for state purposes because it resulted in increased revenue for the state and brought about a more extensive use of I.B.M. equipment.

The adoption of this definition led to the development of problems in certain tax areas, the chief of which were casual sales of personal property on an installment basis, carryback and carryover of net operating losses, carryover of capital losses, and taxability of active duty military service pay in full.

In addition to the minor losses of revenue which Montana sustained because of problems which developed during the transition period there were two areas in which relatively serious losses occurred. These losses were brought about because under the federal definition only fifty per cent of capital gains are taxed and final returns of decedents are not required on an inventory basis.

A careful examination of the Montana Income Tax Law leads to the conclusion that Montana has an income tax with regressive characteristics because federal income taxes are an allowable deduction. It is therefore suggested that federal income taxes be deleted from the list of allowable deductions not only to provide a more progressive tax, but also to facilitate the auditing of returns and to remove the problem now created by federal tax refunds.
An amendment to the tax credit section of the Montana Income Tax Law is also suggested. This amendment would delete tax credit for net income taxes paid to other countries. Such a change is necessary in order to provide equitable tax treatment for various Montana taxpayers.
In order to demonstrate mathematically the regressive nature of the Montana Income Tax Law and to determine the exact point where the regressive characteristic becomes evident, it was necessary to construct several tables. I purposely omitted a description of these tables from the section entitled "Progressive or Regressive Tax" because such description in that section would merely detract from the other points which were being developed. However, it did seem necessary to include somewhere within this paper a discussion of how the tables were set up and of their limitations.

The first problem was to determine how large an interval to set between the various income brackets. I decided to use an interval of $1,000 since the maximum amount that one level could differ from the next, as far as the amount of Montana tax due was concerned, would be $50, and as it turns out there is usually an increase of $30. The tables show adjusted gross income of $1,000 through $45,000 in intervals of $1,000. I did not lengthen the table into any higher income brackets because I believed that the regressive characteristic would become evident well below $45,000. I decided to base the tables on varying numbers of personal exemptions ranging from one to seven, since any trend in the amount of Montana tax caused by increasing the number of exemptions would be obvious in that range.

As a preliminary computation, the first table represented the amounts of federal income tax that would be paid for the various numbers of personal exemptions at the different income levels. An extract of
Table I appears on page 36. This first table probably represents the weakest link in the attempt to demonstrate the regressive nature of the Montana income tax because certain assumptions which are not totally realistic were necessary before it could be prepared. Before a computation of federal income tax can be made the total amount of deductions must be known in addition to the income and number of personal exemptions which were already "built in" for the tables. This amount representing total deductions could not be a pure guess for each computation but had to have some relationship either to the income level or the tax system and be consistent throughout the table. For this reason, I decided to use a standard ten per cent deduction for each federal income tax computation. I realized, of course, that very few taxpayers in the higher income brackets claim the standard deduction since in most cases they have itemized deductions of a greater amount than the standard deduction and therefore claim the higher amount. This limitation undoubtedly results in a higher federal income tax figure than would actually be paid, but the effect on the rest of the tables is not serious since the same deduction is used for the varying numbers of personal exemptions at any one income level.

The computation of Montana income tax was made on seven tables, each representing a different number of personal exemptions. An extract of Tables II through VIII appears on page 36. The same income levels were used for these tables as had been used in computing federal income tax. Deductions did not cause the same problem as was present in the computations on the first table. Part of total deductions was the amount of federal tax that had been computed on Table I and the balance...
represented five per cent of adjusted gross income. It has been the experience of the Montana Income Tax Department that on the average return itemized deductions, less federal income tax, usually amount to around five per cent of adjusted gross income. This ratio is used in the preparation of withholding tax tables with favorable results; its use, therefore, seemed to be justified for the computations of Montana income tax which I made.
### Adjusted Amount of Federal Income Tax Due Using:

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>One</th>
<th>Two</th>
<th>Three</th>
<th>Four</th>
<th>Five</th>
<th>Six</th>
<th>Seven</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P/E</td>
<td>P/E</td>
<td>P/E</td>
<td>P/E</td>
<td>P/E</td>
<td>P/E</td>
<td>P/E</td>
</tr>
<tr>
<td>$11,000</td>
<td>$2,436</td>
<td>$1,888</td>
<td>$1,732</td>
<td>$1,592</td>
<td>$1,460</td>
<td>$1,328</td>
<td>$1,196</td>
</tr>
<tr>
<td>$12,000</td>
<td>$2,792</td>
<td>$2,148</td>
<td>$1,992</td>
<td>$1,836</td>
<td>$1,680</td>
<td>$1,548</td>
<td>$1,416</td>
</tr>
<tr>
<td>$13,000</td>
<td>$3,172</td>
<td>$2,408</td>
<td>$2,252</td>
<td>$2,096</td>
<td>$1,940</td>
<td>$1,784</td>
<td>$1,636</td>
</tr>
<tr>
<td>$14,000</td>
<td>$3,572</td>
<td>$2,668</td>
<td>$2,512</td>
<td>$2,356</td>
<td>$2,200</td>
<td>$2,044</td>
<td>$1,888</td>
</tr>
<tr>
<td>$15,000</td>
<td>$4,002</td>
<td>$2,960</td>
<td>$2,780</td>
<td>$2,616</td>
<td>$2,460</td>
<td>$2,304</td>
<td>$2,148</td>
</tr>
</tbody>
</table>

* P/E = Personal Exemption.

### EXTRACT OF TABLES II THROUGH VIII

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Table II using 1 personal exemption:</td>
<td>$12,000</td>
<td>$600</td>
<td>$2,792</td>
<td>$3,392</td>
<td>$8,608</td>
<td>$8,008</td>
</tr>
<tr>
<td>Table III using 2 personal exemptions:</td>
<td>$12,000</td>
<td>$600</td>
<td>$2,148</td>
<td>$2,748</td>
<td>$9,252</td>
<td>$8,052</td>
</tr>
<tr>
<td>Table IV using 3 personal exemptions:</td>
<td>$15,000</td>
<td>$750</td>
<td>$2,780</td>
<td>$3,530</td>
<td>$11,470</td>
<td>$9,670</td>
</tr>
<tr>
<td>Table V using 4 personal exemptions:</td>
<td>$18,000</td>
<td>$900</td>
<td>$3,500</td>
<td>$4,400</td>
<td>$13,600</td>
<td>$11,200</td>
</tr>
<tr>
<td>Table VI using 5 personal exemptions:</td>
<td>$20,000</td>
<td>$1,000</td>
<td>$3,920</td>
<td>$4,920</td>
<td>$15,080</td>
<td>$12,080</td>
</tr>
<tr>
<td>Table VII using 6 personal exemptions:</td>
<td>$22,000</td>
<td>$1,100</td>
<td>$4,396</td>
<td>$5,496</td>
<td>$16,504</td>
<td>$12,904</td>
</tr>
<tr>
<td>Table VII using 7 personal exemptions:</td>
<td>$24,000</td>
<td>$1,200</td>
<td>$4,872</td>
<td>$6,072</td>
<td>$17,928</td>
<td>$13,728</td>
</tr>
</tbody>
</table>

Note: The underlined federal income tax amounts illustrate how the information contained in Table I was used in the rest of the tables.
APPENDIX B

The information presented and conclusions reached in Part II as to the effects of the change in the law recommended in that section were based on a random sample of the 1958 Montana income tax returns in the refund and taxable classifications. I did not include non-tax returns for the reason that their inclusion would have the effect of lessening the proportion and degree of change indicated by the new tax. Since the change recommended would not alter the non-tax status of most of these returns, including them would only lengthen the sample unnecessarily.

Tolerance returns, those on which the tax due and withholding or estimate are within one dollar of each other, were excluded from the sample because a very large percentage of them are prepared using the 10% standard deduction. As in the case of non-tax returns, the effect of including tolerance returns would be to bring the average tax of both classifications closer together. However, the absence of tolerance returns from the sample reduces the amount of increased revenue which could be expected if the federal income tax were deleted as an allowable deduction, since this type of return accounts for approximately 10% of the total number of returns filed.

The sample was obtained by selecting every thousandth return. In only two cases was the exact return unavailable. Both times the next highest return, in numerical sequence, was selected. The complete sample consisted of one hundred sixty-seven (167) returns. From each return included in the sample the following information was
was recorded: return number, adjusted gross income, total deductions, federal income tax (if deductions were itemized), net income, personal exemptions, taxable income, and total tax. This information was then used to determine a new total tax which was arrived at by subtracting the federal tax from total deductions and comparing the balance with a standard 10% deduction. Of these two figures the larger one was used in arriving at a new net income from which the personal exemptions were subtracted to obtain new taxable income. It was then just a matter of computation, using 1958 rates, to arrive at the new tax. An extract of the sample appears on page 41.

A standard deviation of $90.83 was arrived at for the original tax and $129.56 for the new tax. The figures were computed by using the formula:

\[
S_x = \sqrt{\frac{nSX^2 - (SX)^2}{n(n-1)}}
\]

in which \( n \) equals the number of units in the sample, \((SX)^2\) equals the sum or total of the amount of tax squared and \(SX^2\) equals the sum or total of the squared tax amounts.

With the results obtained above the next step was the computation of a standard deviation for means of many samples. This was accomplished with the use of the following formula:

\[
S_x = \frac{S_x}{\sqrt{n}}
\]

Here a standard deviation of $7.03 was arrived at for the original tax and $10.03 for the new tax.
At this point it seems wise to include a word of interpretation as to the meaning of the above figures. In both of the cases above I have considered the amount of dispersion that would be found using one standard deviation. This means that the $90.83 represents the upper limit of total tax for 68.27% of the returns; in other words, 68.27% of the refund and taxable returns would show a tax somewhere between zero and $90.83. The results obtained using the second formula indicate that if continued samples were taken 68.27% of the means of these samples would be plus or minus $7.03 of the mean of this sample, which was $40.56. Extending this to the two standard deviation or 95.45% confidence level by multiplying the $7.03 and $10.03 by 1.96, the result is $13.78 for the original tax and $19.65 for the new tax. Thus 95% of the means of additional samples would be between $29.78 and $54.34. At first glance this may appear to be a sizeable interval; however, it does not appear so after considering the fact that the tax may vary from zero to thousands of dollars. For example, one return included in the sample which I took had a tax of $1,019.13.

The total population or, in this case, the total number of Montana income tax returns filed for 1958 exceeds 200,000. In spite of the huge size of the total population there are certain characteristics about it which are known. At the time this sample was taken, detailed information about the 1958 returns was not available. Comparison with the 1957 returns is possible, however, because there were no changes in rates, personal exemptions, or other important
features between 1957 and 1958. The mean for all of the 1957 returns was $35.14, which is $5.42 less than the mean of the sample ($40.56). This is an additional indication that the sample is representative of the total population. An examination of the sample reveals that the average amount of state income tax paid by a resident of Montana is $40.56. After performing the computations described above, mainly the deletion of federal income taxes, the average amount of state income tax paid would be $51.94. Thus the information contained in the sample indicates that Montana would realize an increase of 28% in the revenue obtained from its state income tax if the federal income tax was not allowed as a deduction.
### Extract of the Sample of 1958 Montana Returns

<table>
<thead>
<tr>
<th>Number</th>
<th>Adjusted Gross Income</th>
<th>Total Deductions</th>
<th>Federal Tax</th>
<th>Revised Deductions</th>
<th>Original Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>34,000</td>
<td>$8,575.38</td>
<td>$1,667.52</td>
<td>$1,206.31</td>
<td>$857.54</td>
<td>$6,907.86</td>
</tr>
<tr>
<td>35,000</td>
<td>5,488.03</td>
<td>810.99</td>
<td>638.38</td>
<td>548.80</td>
<td>4,677.04</td>
</tr>
<tr>
<td>36,000</td>
<td>37,704.85</td>
<td>11,422.26</td>
<td>9,465.86</td>
<td>1,956.40</td>
<td>26,282.59</td>
</tr>
<tr>
<td>37,000</td>
<td>6,855.23</td>
<td>1,115.15</td>
<td>575.20</td>
<td>685.52</td>
<td>5,740.08</td>
</tr>
<tr>
<td>38,001</td>
<td>7,959.11</td>
<td>980.52</td>
<td>808.20</td>
<td>795.91</td>
<td>6,978.59</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$7,717.84</td>
<td>$1,800.00</td>
<td>$5,107.86</td>
<td>$5,917.84</td>
<td>$103.78</td>
<td>$132.12</td>
</tr>
<tr>
<td>4,939.23</td>
<td>1,800.00</td>
<td>2,877.04</td>
<td>3,139.23</td>
<td>42.54</td>
<td>48.48</td>
</tr>
<tr>
<td>35,748.45</td>
<td>2,400.00</td>
<td>23,882.59</td>
<td>33,348.45</td>
<td>1,019.13</td>
<td>1,492.42</td>
</tr>
<tr>
<td>6,169.71</td>
<td>3,000.00</td>
<td>2,740.08</td>
<td>3,169.71</td>
<td>39.80</td>
<td>49.24</td>
</tr>
<tr>
<td>7,163.20</td>
<td>3,000.00</td>
<td>3,978.59</td>
<td>4,163.20</td>
<td>69.46</td>
<td>74.90</td>
</tr>
</tbody>
</table>

Note: The information in columns 5, 7, 10, and 12 represent the computations which were made from the basic figures. All other columns represent the information obtained directly from the 1958 Montana returns.