

PREVIOUSLY TAXED INCOME OR GAIN DEDUCTION FOR C-CORPORATIONS



EVALUATION SUMMARY

APRIL 2019
2019-TE11

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1964
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it is likely not being used

WHAT DOES THIS TAX EXPENDITURE DO?

When computing Colorado taxable income, the Previously Taxed Income or Gain Deduction for C-Corporations [Section 39-22-304(3)(e), C.R.S.] allows C-corporations to deduct from their federal taxable income any income or gain that was taxed previously by Colorado prior to 1965, to the extent that it is included in the C-corporation's current federal taxable income.

WHAT DID THE EVALUATION FIND?

Due to its age, it appears unlikely that this expenditure is being used, although we lacked data to confirm this.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not state the purpose of this tax expenditure. We inferred that its purpose is to prevent the double taxation of income or gain that was previously included in the income of the taxpayer, the taxpayer's decedent, or an estate or trust from which the taxpayer received the income or gain and was taxed by Colorado in a tax year prior to 1965.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the deduction since it does not appear to have current or future applicability.

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EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Previously Taxed Income or Gain Deduction for C-Corporations [Section 39-22-304(3)(e), C.R.S.] was created in 1964. Although it was revised in 1987 due to a revision and reenactment of the income tax section in the Colorado Revised Statutes, the operation of the deduction has remained unchanged since its creation.

When computing Colorado taxable income, this deduction allows C-corporations to deduct from their federal taxable income any income or gain that was previously taxed by Colorado prior to 1965, to the extent that it is included in federal taxable income. To qualify for the deduction, the income or gain could have previously been taxed “to the taxpayer..., a decedent [of the taxpayer] by reason of whose death the taxpayer acquired the right to receive the income or gain, or a trust or estate from which the taxpayer received the income or gain.” To claim the deduction, taxpayers include the amount of previously taxed income or gain on Line 13 (“Other Subtractions”) of their state C-Corporation Income Tax Return (Form DR 0112).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Previously Taxed Income or Gain Deduction for C-Corporations. Based on the statutory language of the deduction and interactions between the federal and Colorado income tax systems, we inferred that the intended

beneficiaries of the deduction are C-corporations that have income or gains included in their federal taxable income that were previously taxed by Colorado prior to 1965.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. Based on statute [Section 39-22-304(3)(e), C.R.S.], we inferred that the purpose of the deduction is to prevent the double taxation of income that was taxed by Colorado in a tax year prior to 1965. The General Assembly enacted this deduction in 1964, the same year it established federal taxable income as the starting point for determining Colorado taxable income for C-corporations. Therefore, it is likely that this deduction was a transitional and structural provision necessary to prevent double taxation at the state level of transactions that were previously taxed differently by the State and the federal government. In particular, this provision may have been needed to avoid the double taxation of installment sales which occurred prior to 1965. With installment sales, a corporation would receive income from payments over multiple years. Due to possible differences in how state and federal income was calculated prior to 1965, the corporation may have been required to recognize more of this income at the state level sooner than at the federal level and would have therefore, paid state income taxes on this income earlier than federal income taxes. When the State began using federal taxable income as the basis for Colorado taxable income, if any of the income included in federal income had already been taxed by the state, the corporation could have been double taxed.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that this tax expenditure is no longer meeting its purpose because it is likely not used by taxpayers and is unlikely to be used in future years. Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the

following performance measure to determine the extent to which the Previously Taxed Income or Gain Deduction for C-Corporations is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are C-corporations using the deduction to prevent the double taxation of income or gain previously taxed in Colorado in a tax year prior to 1965?*

RESULT: It appears likely that the deduction is not being used. However, we were unable to confirm whether any taxpayers have claimed this deduction in recent years due to a lack of data. We consulted with several certified public accountants practicing in Colorado, and they had either not heard of the deduction or could not think of a situation in which a corporation would be able to use this deduction now or in the future. Additionally, in order for this deduction to be used, a corporation must have included the income or gain in its current federal taxable income, and it must have also been taxed by Colorado on the income or gain over 54 years ago. We were not able to identify a likely scenario where this situation would occur. Given this large timespan, which will only continue to grow, it seems unlikely that taxpayers will use the deduction in future years.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

We did not identify any economic costs or benefits of the deduction since it is likely not being used.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Because it is not likely being used, if the deduction was eliminated, there would be no impact on intended beneficiaries.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

We identified several other states and jurisdictions with a similar deduction or exemption, including Alabama, the District of Columbia, Missouri, North Carolina, Utah, and Wisconsin. Missouri's deduction replicates Colorado's statutory language nearly verbatim, and the date in its statute corresponds to the date that Missouri began using federal taxable income as the starting point for calculating Missouri taxable income for corporations.

Additionally, we identified a parallel deduction available in Colorado for individuals, estates, and trusts [Section 39-22-104(4)(c), C.R.S.], but that provision does not restrict the deduction to income or gains taxed prior to January 1, 1965. Department of Revenue staff reported that the deduction available to individuals, estates, and trusts is claimed with some frequency by individuals. We will be evaluating this deduction in a future year.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

The Department of Revenue was not able to provide us with data to confirm whether any C-corporations claimed the deduction. Currently, C-corporations would claim the deduction on Line 13 ("Other Subtractions") of the C-Corporation Income Tax Return (Form DR 0112), which aggregates several deductions. Therefore, the Department of Revenue does not have data specific to this deduction.

To accurately determine if any taxpayers took this deduction and its revenue impact, the Department of Revenue would have to create a new reporting line on the DR 0112 and then capture and house the data collected on that line, which according to the Department, would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2018 Tax Expenditures Compilations Report* for additional details on the

limitations of Department of Revenue data and the potential costs of addressing the limitations). Since it is likely that taxpayers are not claiming this deduction, it may not be worth the additional expense to amend the DR 0112.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the Previously Taxed Income or Gain Deduction for C-Corporations since it does not appear likely to have current or future applicability.