

COLORADO NET OPERATING LOSS DEDUCTION FOR C-CORPORATIONS

EVALUATION SUMMARY



JULY 2019
2019-TE16

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

| | |
|----------------------------|-------------------------------------|
| YEAR ENACTED | 1964 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | Between \$154.8 and \$308.2 million |
| | TAX YEAR 2015 |
| NUMBER OF TAXPAYERS | Between 7,500 and 8,500 |
| AVERAGE TAXPAYER BENEFIT | Between \$21,000 and \$36,000 |
| IS IT MEETING ITS PURPOSE? | Yes |

WHAT DOES THIS TAX EXPENDITURE DO?

The Colorado Net Operating Loss Deduction for C-corporations [Section 39-22-304(3)(g), C.R.S.] allows C-corporations to deduct net operating losses from prior tax years from their Colorado taxable income.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether (1) the State should establish its own net operating loss carryforward period rather than conforming to the federal indefinite carryforward period; (2) the annual federal net operating loss deduction cap applies in Colorado; and (3) to repeal the 15-year carryforward period for financial institutions, which is generally obsolete.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. We inferred that the purpose is to allow C-corporations to use their net operating losses to reduce taxable income and offset their income tax liability in future years, allowing them to smooth their income and tax liability across the business cycle.

WHAT DID THE EVALUATION FIND?

We determined that the tax expenditure is generally accomplishing its purpose since C-corporations, and the CPAs who prepare their returns, are aware of it and use it to smooth their income across the business cycle.

COLORADO NET OPERATING LOSS DEDUCTION FOR C- CORPORATIONS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Colorado Net Operating Loss Deduction for C-corporations (Corporate Net Operating Loss Deduction) [Section 39-22-304(3)(g), C.R.S.] allows C-corporations to deduct Colorado net operating losses carried forward from prior tax years when computing Colorado taxable income.

A net operating loss occurs when a taxpayer's allowable deductions exceed their income for the tax year. In general, a net operating loss means that a taxpayer has "negative income" in a particular tax year and does not have income tax liability in that year. A net operating loss carryback or carryforward allows a taxpayer to use their net operating loss in past or future years to offset income in a taxable year in which they generate income. This can ultimately reduce the taxpayer's tax liability across multiple years. A net operating loss carryback results in an immediate refund to the taxpayer whereas a net operating loss carryforward results in a lower tax liability in future years.

House Bill 64-1003 created the Corporate Net Operating Loss Deduction, which became effective January 1, 1965. The bill also established federal taxable income as the starting point for calculating Colorado taxable income for corporations. The deduction has undergone several substantial changes since its enactment, shown in EXHIBIT 1.1.

| EXHIBIT 1.1. LEGISLATIVE HISTORY OF THE CORPORATE NET OPERATING LOSS DEDUCTION | |
|--|---|
| BILL | DESCRIPTION OF MODIFICATION |
| HB 64-1003 | Required the use of federal taxable income as the starting point for determining Colorado taxable income for C-corporations and created the Corporate Net Operating Loss Deduction. |
| HB 83-1595 | Removed the provision that allowed taxpayers to carry back a net operating loss for tax years beginning on or after January 1, 1984. |
| HB 87-1243 | Established a net operating loss carryforward period of 15 years for financial institutions that suffer a net operating loss in a taxable year beginning on or after January 1, 1984. |
| HB 10-1199 | Disallowed net operating loss deductions in excess of \$250,000 for C-corporations for tax years beginning on or after January 1, 2011, but prior to January 1, 2014. Also provided that a net operating loss could be carried forward for one additional year for each tax year that a C-corporation was not permitted to use the loss due to this limitation, and C-corporations were allowed interest at a rate of 3.25 percent per annum for the period during which the loss was disallowed. |
| SOURCE: Office of the State Auditor analysis of legislative history of the Corporate Net Operating Loss Deduction. | |

Federal law [26 USC 172] also provides for a corporate net operating loss deduction for taxpayers when calculating their federal taxable income. However, statute [Section 39-22-304(2)(c), C.R.S.] disallows the federal net operating loss deduction for state tax purposes and requires that the federal net operating loss deduction be added back to a C-corporation's federal taxable income when determining Colorado taxable income. Taxpayers can then use the Corporate Net Operating Loss Deduction as calculated under Section 39-22-504, C.R.S. to deduct net operating losses carried forward from prior years.

Statute [Sections 39-22-504(1) and (3), C.R.S.] provides that:

- 1 A net operating loss is allowed in the same manner that it is allowed under the Internal Revenue Code, except as otherwise provided.
- 2 C-corporations may carry forward their Colorado net operating losses for the same number of years allowed by the Internal Revenue Code for a federal net operating loss.
- 3 C-corporations may not carry back Colorado net operating losses regardless of whether they are allowed for federal tax purposes.

- 4 For taxpayers that are required to apportion income (i.e., because they do business in multiple states), the Colorado net operating loss deduction is limited to the portion of the federal net operating loss that is apportioned to Colorado.

C-corporations claim the Corporate Net Operating Loss Deduction on Line 17 (“Colorado Net Operating Loss Deduction”) of the Colorado C-Corporation Income Tax Return (Form DR 0112). EXHIBIT 1.2 provides an example of how the Corporate Net Operating Loss Deduction is calculated for a hypothetical corporation.

| EXHIBIT 1.2. CORPORATE NET OPERATING LOSS DEDUCTION CALCULATION FOR A HYPOTHETICAL CORPORATION ¹ | | | |
|---|-----------------------|------------------|--------------|
| | YEAR 1 (LOSS YEAR) | YEAR 2 | YEAR 3 |
| Colorado Taxable Income/(Loss) Before Corporate Net Operating Loss Deduction | (\$2,000,000) | \$1,500,000 | \$2,800,000 |
| Corporate Net Operating Loss Deduction | -\$0 | -\$1,500,000 | -\$500,000 |
| Colorado Taxable Income | =(\$2,000,000) | =\$0 | =\$2,300,000 |
| Colorado Net Operating Loss Carryforward Amount | \$2,000,000 | \$500,000 | \$0 |
| Colorado Tax Liability (Colorado Taxable Income x 4.63 percent) | \$0 | \$0 | \$106,490 |
| TOTAL COLORADO TAX LIABILITY IN ALL 3 YEARS | | \$106,490 | |

SOURCE: Office of the State Auditor analysis of Sections 39-22-304(3)(g) and 39-22-504(1) and (3), C.R.S.

¹ Calculations assume that the federal limit on the deduction amount established under the 2017 Tax Cuts and Jobs Act, as discussed below, does not apply for Colorado tax purposes.

Recent changes to federal law have resulted in changes to the application of the Corporate Net Operating Loss Deduction. Specifically, prior to the enactment of the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97], under federal law [26 USC 172(b)(1)(A)], taxpayers could generally carry net operating losses back for 2 years and forward for 20 years. Additionally, a net operating loss deduction could fully offset the taxable income of a taxpayer. Thus, under Sections 39-22-504(1) and (3), C.R.S., for state tax purposes, corporations could also carry forward net operating losses for a maximum of 20 years, but could not carry back losses as allowed

at the federal level since carrybacks are specifically disallowed by statute for Colorado tax purposes.

However, changes to the federal net operating loss deduction as a result of Pub. L. 115-97, which went into effect for tax years ending after December 31, 2017, include:

- Disallowance of net operating loss carrybacks.
- Indefinite carryforward of net operating losses.
- Limit on the annual net operating loss deduction amount to the lesser of (1) the available net operating loss carryforward, or (2) 80 percent of the taxpayer's federal taxable income as calculated prior to applying the net operating loss deduction (this provision is effective for tax years beginning after December 31, 2017).

Since Colorado generally conforms to the federal treatment of net operating loss deductions, this federal legislation changed the calculation and carryforward periods of the Corporate Net Operating Loss Deduction when the loss is generated in a tax year ending after December 31, 2017. Specifically, for tax years ending after December 31, 2017, corporations can carry forward losses indefinitely for state tax purposes, as opposed to 20 years for losses incurred during prior years. However, it is unclear whether the new federal limit on the deduction amount applies for Colorado tax purposes (see the *What policy considerations did the evaluation identify?* section below for additional details on this issue).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Corporate Net Operating Loss Deduction. Based on the statutory language of the deduction and interactions between federal and Colorado tax laws, we inferred that the intended beneficiaries of the deduction are C-corporations that do business in Colorado and have net operating losses in some years. Because it is common for corporations to incur

losses in some years, with the expectation of gains in future years, the deduction applies to a broad range of businesses in the state.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. Based on federal and state statutes, federal Joint Committee on Taxation reports, and discussions with Certified Public Accountants (CPAs) in Colorado, we inferred that the purpose of the Corporate Net Operating Loss Deduction is to allow C-corporations to use their net operating losses to reduce taxable income and offset their income tax liability in future years. This is a common structural provision in states with a corporate income tax and allows businesses to smooth their income and tax liability across multiple years, which may better reflect the typical business cycle of investment, losses, and gains.

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

We determined that the Corporate Net Operating Loss Deduction is generally accomplishing its purpose since C-corporations, and the CPAs who prepare their tax returns, are aware of it and use it to smooth their income across the business cycle.

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 Corporate Net Operating Loss Deduction is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent are C-corporations doing business in Colorado using the Corporate Net Operating Loss Deduction to reduce taxable income and offset tax liabilities?*

RESULT: In Tax Year 2015 (the most recent year that complete data were available), about 50,000 C-corporations filed a Colorado corporate income tax return, and about 8,500 (17 percent) of them claimed the Corporate Net Operating Loss Deduction. We were unable

to locate data that would have indicated how many C-corporations in Colorado had a net operating loss from prior years and were potentially eligible for the deduction in order to determine what percentage of eligible corporations actually claimed it. However, we consulted with several CPAs in Colorado that work with C-corporations, and they were all aware of the deduction and indicated that it is widely used.

The Corporate Net Operating Loss Deduction allowed corporations that claimed it to significantly reduce their taxable income. Specifically, as shown in EXHIBIT 1.3, most corporations that took the deduction were able to reduce their taxable income to between \$0 and \$9,999. On average, these corporations would have had \$382,000 in additional taxable income without the deduction. EXHIBIT 1.3 shows the breakdown of C-corporations claiming the Corporate Net Operating Loss Deduction in Tax Year 2015 by the amount of Colorado taxable income they had after applying the deduction.

**EXHIBIT 1.3.
COLORADO NET OPERATING LOSS DEDUCTION CLAIMS BY
C-CORPORATIONS BASED ON
COLORADO TAXABLE INCOME AFTER THE DEDUCTION
TAX YEAR 2015**

| COLORADO TAXABLE INCOME AFTER APPLYING THE DEDUCTION | NUMBER OF RETURNS | TOTAL DEDUCTION AMOUNT | AVERAGE DEDUCTION AMOUNT PER RETURN |
|--|-------------------|------------------------|-------------------------------------|
| Negative Taxable Income ¹ | 992 | \$3,313,188,000 | \$3,340,000 |
| \$0 to \$9,999 | 6,176 | \$2,356,148,000 | \$382,000 |
| \$10,000 to \$99,999 | 750 | \$65,631,000 | \$88,000 |
| \$100,000 to \$999,999 | 380 | \$145,686,000 | \$383,000 |
| \$1,000,000 and Over | 185 | \$776,048,000 | \$4,195,000 |
| TOTAL | 8,483 | \$6,656,701,000 | \$785,000 |

SOURCE: Office of the State Auditor analysis of Colorado Department of Revenue Statistics of Income data.

¹ The Corporate Net Operating Loss Deduction cannot generate a tax refund and should not cause a taxpayer to have negative taxable income. However, Department of Revenue staff indicated that some of the 992 taxpayers with negative taxable income after applying the deduction may have inappropriately reported the Corporate Net Operating Loss Deduction on their returns as a means of tracking their net operating loss carryforwards. See discussion in the “What are the Economic Costs and Benefits of this Tax Expenditure?” section for more information on taxpayers with negative taxable income that claimed the Corporate Net Operating Loss Deduction.

In Tax Year 2015, nearly 85 percent of C-corporations that claimed the Corporate Net Operating Loss Deduction had Colorado taxable income

under \$10,000 after applying the Deduction. We examined Department of Revenue Statistics of Income data from Tax Years 2009, 2011, and 2013, and generally found the same pattern in those years: C-corporations with under \$10,000 of Colorado taxable income after applying the Deduction represented the majority of C-corporation claimants of the Corporate Net Operating Loss Deduction. In addition, they consistently claimed a large portion of the total amount of Corporate Net Operating Loss Deductions, even when the Corporate Net Operating Loss Deduction caps were in place in 2011 and 2013.

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

Based on Department of Revenue taxpayer data, we estimated that the Corporate Net Operating Loss Deduction resulted in between \$154.8 million and \$308.2 million of forgone income tax revenue to the State in Tax Year 2015. We provided this range because we could not reliably estimate the revenue impact for taxpayers who claimed the deduction, but also reported having negative taxable income for the year. Specifically, Department of Revenue data indicate that in Tax Year 2015, 992 taxpayers with negative Colorado taxable income claimed the Corporate Net Operating Loss Deduction, for a total of about \$3.3 billion in deductions (about half of all the deductions claimed). Department of Revenue staff reported that some of these taxpayers may report the Corporate Net Operating Loss Deduction inappropriately on their returns as a means of tracking their net operating loss carryforward, which inflates the amount of Net Operating Loss Deductions reported, but does not actually impact their tax liability or have a revenue impact to the State for the year reported. The Department of Revenue could not provide additional data necessary to determine the portion of deductions reported by these taxpayers that actually reduced their tax liability. The \$308.2 million figure is the revenue impact if all of these taxpayers were able to apply the full value of the deductions they reported. The \$154.8 million figure shows the revenue impact if none of the deductions reported by these taxpayers actually reduced their tax liability in Tax Year 2015.

The 2017 Tax Cuts and Jobs Act [Pub. L. 115-97] made several changes

to the federal net operating loss deduction and other federal tax deductions, which may temporarily or indefinitely affect the revenue impact of the Corporate Net Operating Loss Deduction. These changes and their anticipated impact on the Corporate Net Operating Loss Deduction include:

- **BONUS DEPRECIATION UNDER 26 USC 168.** This provision allows taxpayers to fully depreciate certain types of property in the year it is acquired and placed in service, rather than spread the depreciation out over multiple years. Specifically, certain property acquired and placed in service after September 27, 2017, but before January 1, 2023, is eligible to be fully depreciated (i.e., fully deducted) in the year in which it is acquired and placed in service. In addition, for property acquired and placed in service after December 31, 2022, but before January 1, 2027, the first year depreciation allowance ranges from 20 percent to 80 percent of the depreciable basis of the property. Depreciation is an expense that reduces gross income. By claiming a larger depreciation expense in the first year, taxpayers could have a larger net operating loss in the first year, which could also result in a larger state revenue impact in the years immediately following the loss year. However, because C-corporations would depreciate the property over time anyway, it is a timing difference for the revenue impact rather than an increase in the cumulative revenue impact. The impact of the bonus depreciation provision on the Corporate Net Operating Loss Deduction will be temporary as the provision expires on December 31, 2026.
- **INDEFINITE CARRYFORWARDS OF NET OPERATING LOSSES UNDER 26 USC 172.** Federal net operating losses can now be carried forward indefinitely. Previously, for most C-corporations, federal net operating loss deductions could be carried forward for 20 years. Because statute [Section 39-22-504(3), C.R.S.] generally conforms to federal net operating loss carryforward periods, the Colorado net operating loss carryforward period will also be indefinite for net operating losses generated in taxable years ending after December 31, 2017. This may result in a larger cumulative state revenue

impact, but only to the extent that C-corporations previously had not been able to use all of their net operating losses before they expired. This impact to the Corporate Net Operating Loss Deduction will be permanent.

- **LIMIT ON AMOUNT OF ANNUAL FEDERAL NET OPERATING LOSS DEDUCTION ALLOWED UNDER 26 USC 172.** The annual federal net operating loss deduction is now capped at the lesser of (1) the available net operating loss carryforward, or (2) 80 percent of the taxpayer's federal taxable income as calculated prior to applying the net operating loss deduction. Because statute [Section 39-22-504(1), C.R.S.] provides that Colorado net operating losses are generally allowed in the same manner for state purposes as federal purposes, it is possible that the federal net operating loss annual cap will apply for state purposes. This may result in a lower annual state revenue impact for the deduction; however, since net operating loss deductions may be carried forward indefinitely, it may not result in a lower cumulative revenue impact. It is unclear whether this federal law provision will apply to Colorado net operating loss deductions since the federal net operating loss deduction is added back when calculating Colorado taxable income and the Department of Revenue has not issued any guidance on this issue (see "What Policy Considerations Did the Evaluation Identify?" section below for further discussion). If applicable, this impact to the Corporate Net Operating Loss Deduction would be permanent.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Corporate Net Operating Loss Deduction were eliminated, it would result in many C-corporations that are doing business in Colorado incurring a higher state income tax liability. Overall, eliminating the deduction would have increased corporate tax liabilities in Tax Year 2015 between \$154.8 million and \$308.2 million, which would be an increase of 24 to 47 percent based on the \$652.3 million in total corporate income tax that the State collected during Fiscal Year 2016. In addition, because every other state that levies a corporate

income tax provides some form of net operating loss deduction, eliminating it would cause Colorado to be an outlier among the states and could make it less attractive for corporations to locate and do business in the state. For example, one CPA we contacted regarding their clients' use of the deduction mentioned that, to the extent it was not too inconvenient to relocate, elimination of the Corporate Net Operating Loss Deduction could result in some C-corporations relocating their businesses to other states. However, we were unable to measure the extent to which that may happen.

We examined Internal Revenue Service statistics of income data and found that the industries claiming the most federal net operating loss deductions on their federal returns are finance and insurance (32 percent of federal net operating loss deductions); manufacturing (21 percent); and information (10 percent), which includes major industries such as newspaper publishing, software publishing, wired and wireless telecommunication carriers, and cable and other subscription programming. We were unable to find a source of data for the industries that claimed the most Colorado Corporate Net Operating Loss Deductions. However, to the extent that the federal breakdown is similar to the Colorado breakdown, those industries, except for insurance companies, which in Colorado are subject to a gross premiums tax rather than an income tax, would potentially be most impacted by the elimination of the Corporate Net Operating Loss Deduction.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Forty-four states (other than Colorado) and the District of Columbia impose a corporate income-based tax. All of these states and the District of Columbia provide net operating loss deductions for C-corporations. However, they vary in:

- **THE LENGTH OF THE CARRYFORWARD PERIOD.** All states with a corporate income tax and the District of Columbia allow net operating loss deductions to be carried forward. Thirteen states and

the District of Columbia conform to new federal law changes [Pub. L. 115-97] that allow net operating losses to be carried forward indefinitely, and one state (Utah) has incorporated an indefinite carry forward period by statute independent of federal law. Thirty states have decoupled from the *Internal Revenue Code* regarding net operating loss carryforward periods, with 16 states adopting the former federal carryforward period of 20 years. Two states, Arkansas and Rhode Island, limit the carryforward period to 5 years, which is the shortest carryforward period offered among the states.

- **THE ALLOWANCE OF CARRYBACKS.** As of February 2019, only six states allow net operating losses to be carried back. The longest carryback period among these states is 3 years (Montana and New York).
- **ANNUAL LIMITS ON THE NET OPERATING LOSS DEDUCTION.** Three states (Connecticut, Pennsylvania, and Utah) impose their own annual limit on the amount of a net operating loss deduction, independent of the federal limit, that may be claimed. These states limit the deduction to a percentage of state net or taxable income. Additionally, New Hampshire limits the total amount of a net operating loss that may be carried forward to \$10 million.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

We did not identify other tax expenditures or programs with a similar purpose available in the State.

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

The Department of Revenue was unable to provide us with detailed data on taxpayers that had negative Colorado taxable income that claimed the Corporate Net Operating Loss Deduction. Specifically, for Tax Year 2015, taxpayers reported their Colorado taxable income before the Corporate Net Operating Loss Deduction on Line 15 of Form DR 0112, claim the Corporate Net Operating Loss Deduction on Line 16, and then report their final Colorado taxable income, the amount on which

their Colorado income tax liability is based, on Line 17. Department of Revenue staff indicated that some taxpayers with negative taxable income on Line 17 also had negative taxable income on Line 15, which means that any amount they claimed on Line 16 (the Corporate Net Operating Loss Deduction) would not have an impact on state tax revenue in that tax year. However, the Department of Revenue was not able to provide us with detailed data that would have allowed us to determine how many taxpayers with negative taxable income on Line 17 had positive taxable income on Line 15, in which case the Corporate Net Operating Loss Deduction they claimed would have an impact on state tax revenue. Without this data, we were only able to provide a range of the revenue impact to the State due to the Corporate Net Operating Loss Deduction.

The Department of Revenue was also unable to provide us with data on the gross revenue, or another similar metric, or the industry type of C-corporations claiming the Corporate Net Operating Loss Deduction. This data would have allowed us to determine the size and type of the businesses claiming the deduction to better understand the relative benefit it provides taxpayers. Because Colorado uses federal taxable income as the starting point for calculating state corporate income tax, the Department of Revenue does not require corporations to report gross revenue and does not have a line on Form DR 0112 to collect it. Furthermore, although taxpayers are required to enter an industry code on Form DR 0112, the Department is not able to extract this information from GenTax, the Department of Revenue's tax processing system. Adding a line to the form and programming GenTax to capture and house this information 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).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE STATE

SHOULD ESTABLISH ITS OWN NET OPERATING LOSS CARRYFORWARD PERIOD RATHER THAN CONFORMING TO THE FEDERAL INDEFINITE CARRYFORWARD PERIOD. When the General Assembly established the Corporate Net Operating Loss Deduction, federal law limited the number of years a corporation could carry forward net operation losses. Thus, it is unclear whether the General Assembly intended to allow for indefinite carryforwards when it tied the State's maximum carryforward period to the federal carryforward period. Allowing net operating losses to be carried forward for extended periods, or indefinitely, may impact the State's ability to forecast its revenue and could potentially result in a larger cumulative revenue impact to the extent that some corporations had previously not been able to use all of their net operating losses before they expired. Colorado has historically deviated from one of the federal requirements when, in 1983, the General Assembly eliminated the carryback provision.

On the other hand, indefinite carryforward periods may help corporations that do not generate income for long periods of time by allowing them to retain their net operating loss deductions indefinitely. In addition, the State's conformance to federal law regarding the carryforward period could make it easier for corporations and the State to administer since doing so avoids the need to maintain a separate calculation for the carryforwards available for state and federal purposes.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING WHETHER THE ANNUAL FEDERAL NET OPERATING LOSS DEDUCTION CAP APPLIES IN COLORADO. Statute [Section 39-22-504(1), C.R.S.] provides, "A net operating loss deduction shall be allowed in the same manner that it is allowed under the internal revenue code except as otherwise provided in this section." However, this statutory language was established prior to the federal 2017 Tax Cuts and Jobs Act, which placed a cap on federal net operating loss deductions at the lesser of the taxpayer's aggregate net operating loss carryforwards and carrybacks for the year or 80 percent of taxpayers' federal taxable income before the federal net operating loss deduction. For example, a corporation

with \$200,000 in net operating losses carried forward from prior years and \$100,000 in federal taxable income during a tax year would only be able to claim an \$80,000 net operating loss deduction (80 percent of its federal taxable income) for federal tax purposes that year, whereas prior to this change it could have claimed a \$100,000 deduction (the full amount of its federal taxable income). It is unclear if this provision applies to the state because the federal net operating loss deduction is added back to federal taxable income for state tax purposes when applying the Corporate Net Operating Loss Deduction at the state level. The Department of Revenue has not issued any rules or guidance related to this issue, although its staff have indicated that they are reviewing it. At least one other state (Georgia) has added language to its statute to clarify that the federal 80 percent cap applies for state purposes.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE PROVISION THAT ALLOWS FINANCIAL INSTITUTIONS TO CARRY NET OPERATING LOSSES FORWARD FOR 15 YEARS [SECTION 39-22-504(4), C.R.S.]. Statute [Section 39-22-504(4), C.R.S.] provides, “If a financial institution suffers a net operating loss for any taxable year beginning on or after January 1, 1984, the amount of the unused net operating loss may be carried forward to each of the fifteen years following the taxable year of such loss.” When this provision was enacted in 1987, for federal income tax purposes, federal law [26 USC 172(b)(1)(F)] provided that financial institutions were only allowed to carry losses forward for five years, as compared to 15 years for other corporations. Since for state tax purposes, statute [Section 39-22-504(3), C.R.S.] provided that “[n]et operating losses of corporations may be carried forward for the same number of years as allowed for a federal net operating loss,” the General Assembly likely enacted Section 39-22-504(4), C.R.S. to allow financial institutions to be treated equally to other taxpayers. However, current federal law [26 USC 172] no longer provides different net operating loss carryback or carryforward periods for financial institutions for federal tax purposes.

Additionally, since current statute [Section 39-22-504(3), C.R.S.] provides that “[n]et operating losses of corporations may be carried

forward for the same number of years as allowed for a federal net operating loss,” it is likely that financial institutions can use this provision to carry current net operating losses forward indefinitely since statute uses “may” rather than “must” or “shall” in both Sections 39-22-504(3) and (4), C.R.S. However, leaving Section 39-22-504(4), C.R.S., in statute may create confusion for some taxpayers. Additionally, if federal law changes so that the federal net operating loss carryforward period is less than 15 years, Colorado’s current statute [Section 39-22-504(4), C.R.S.] would allow financial institutions to carry forward a net operating loss for longer than the federal carryforward period, which may give financial institutions an advantage and not be consistent with the General Assembly’s intentions when it enacted that provision.