



PREVIOUSLY TAXED INCOME DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION SUMMARY | APRIL 2021 | 2021-TE9

TAX TYPE	Income	REVENUE (TAX YEAR 2018)	\$865,000
YEAR ENACTED	1964	NUMBER OF TAXPAYERS	2,700
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: Eligible taxpayers appear to be aware of and use the deduction, which allows them to avoid paying tax on income that the State has already taxed in previous years.

WHAT DOES THE TAX EXPENDITURE DO?

The Previously Taxed Income Deduction for Individuals, Estates, and Trusts allows individual, estate, and trust taxpayers to deduct any income or gain that was previously taxed by Colorado when calculating Colorado taxable income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Previously Taxed Income Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the deduction, the legislative history of the deduction and income taxes in Colorado, and discussions with Department of Revenue staff, we considered a potential purpose: to reconcile differences between state and federal tax law and prevent the State from taxing the same income twice.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the deduction.
- Whether taxpayers who claimed a tax credit pursuant to section 1341 of the Internal Revenue Code should be allowed to claim the deduction.



PREVIOUSLY TAXED INCOME DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Previously Taxed Income Deduction for Individuals, Estates, and Trusts [Section 39-22-104(4)(c), C.R.S.] (Previously Taxed Income Deduction) allows taxpayers who file as individuals, estates, or trusts to deduct from their federal taxable income any income or gain that was previously taxed by Colorado when calculating Colorado taxable income. Colorado uses federal taxable income, which is calculated by subtracting federal deductions from gross income, as the starting point for determining Colorado taxable income. Therefore, any income included or deductions allowed in calculating federal taxable income automatically apply in Colorado unless Colorado statutes specifically require taxpayers to add back the amount they claimed for a federal deduction or to subtract certain types of income included in federal taxable income.

Currently, Colorado generally conforms to federal tax treatment of income and gains with regard to when they are taxed. However, in the past, there have been periods in which the tax treatment of deferred compensation, such as certain retirement and pension plans, was different for Colorado and federal income tax purposes. Specifically, employee contributions made to the Public Employee Retirement Association (PERA) from July 1, 1984, to December 31, 1986, and employee contributions made to the Denver Public Schools Retirement System (DPSRS) from January 1, 1986, to December 31, 1986, were taxed by the State when the contributions were made, but the contributions were tax-deferred for federal tax purposes. This

discrepancy occurred due to changes in federal law in 1984 (for PERA) and 1986 (for DPSRS) that made those contributions tax-deferred, and there was a delay between the time federal law changed and the General Assembly changed Colorado law to conform to the tax treatment of these retirement contributions. When employees who contributed to PERA or DPSRS during those dates receive their benefits, the pension income is included in federal taxable income. The Previously Taxed Income Deduction allows those employees to deduct the amount of income on which they already paid Colorado income tax. For example, if a state employee contributed \$10,000 to PERA in 1986, when that employee retires and begins receiving retirement benefits, they are eligible to deduct \$10,000 when calculating their Colorado taxable income, since they paid Colorado income tax when that \$10,000 was contributed to PERA. If a taxpayer does not have enough taxable income in the year they retire to claim the entire deduction, they can continue to claim it until they have received the entire deduction amount that they are entitled to claim. It is possible some taxpayers besides PERA and DPSRS members have income previously taxed by the State; however, we spoke with Department of Revenue (Department) staff and a certified public accountant (CPA) in Colorado, and they were not aware of any other reasons to use the deduction.

The Previously Taxed Income Deduction was created in 1964 with House Bill 64-1003, which is the same legislation that established federal income as the starting point for determining Colorado taxable income. The operation of the deduction has remained unchanged since its creation, although it was revised in 1987 with House Bill 87-1331 as part of a revision and reenactment of the income tax section in the Colorado Revised Statutes.

Individuals claim the Previously Taxed Income Deduction on Line 11 (for eligible PERA/DPSRS-related income) or Line 19 (for other previously taxed income) of the Subtractions from Income Schedule (Form DR 0104AD), which gets attached to the Individual Income Tax Return (Form DR 0104). Estates and trusts claim the deduction on

Line 5 (subtractions from federal taxable income) of the Fiduciary Income Tax Return (Form DR 0105).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Previously Taxed Income Deduction. Because the deduction applies to individuals, estates, and trusts who have previously taxed income included in their federal taxable income, we inferred that they are the intended beneficiaries of the deduction. In particular, this tax expenditure appears to benefit PERA and DPSRS members who made contributions in 1984 through 1986, at which time the contributions were taxed by the State, but tax-deferred for federal tax purposes. According to data from PERA, there were, on average, about 98,000 contributing PERA members each year in 1984 through 1986 and about 6,000 DPSRS members in 1986.

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

We could not definitively determine whether the Previously Taxed Income Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to

conduct this evaluation because eligible taxpayers are likely claiming it to reconcile differences between their state and federal taxable income.

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 deduction is meeting its inferred purpose:

PERFORMANCE MEASURE: To what extent are eligible taxpayers using the deduction to prevent double taxation on income that was previously taxed by the State?

RESULT: In Tax Year 2018, which was the most recent year of data available, the Previously Taxed Income Deduction was claimed for PERA and/or DPSRS contributions on just under 2,700 individual income tax returns. Although we lacked data on the total amount of potentially eligible taxpayers (i.e., State and DPS employees who worked in 1984, 1985, or 1986 and who retired in 2018, as well as taxpayers with other previously taxed income), the number of claims in Tax Year 2018 indicates that many eligible taxpayers are aware of and use it.

Additionally, information about this deduction is widely available from several sources, which indicates that eligible taxpayers are likely to learn of the exemption and claim it. Specifically, there is a dedicated line for this deduction for PERA/DPSRS 1984-1986 contributions on the Subtractions from Income Schedule (Form DR 0104AD), which is part of the Individual Income Tax Return (Form DR 0104); the return instructions include information on who is eligible and how to claim the deduction. The Department also has published a taxpayer guide about the deduction that is available on its website. PERA includes information about this deduction in its *Taxes on PERA Benefits* booklet, which is included in its retirement kit for soon-to-be retirees. PERA staff indicated that they believe most retirees are aware of the deduction, that retirees can contact PERA to receive a letter that provides them with the amount of contributions made in the eligible

years, and that some retirees can access this information on demand through their personalized secure account. TurboTax, a tax preparation software that taxpayers can use to prepare and file their own taxes, also provides information about this deduction. We also consulted with a CPA in Colorado and they were aware of the deduction, and believe professional tax-return preparers in Colorado are aware of it, but that most taxpayers may not be. However, the CPA reported that they believe most eligible taxpayers would already have claimed the deduction.

We lacked information and data on claims of this deduction for previously taxed income other than 1984-1986 PERA or 1986 DPSRS contributions. However, because Colorado generally conforms to federal law regarding the timing of the taxation of income, Department staff reported that claims of this deduction for previously taxed income other than 1984-1986 PERA or 1986 DPSRS contributions would be rare.

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

According to Department data, in Tax Year 2018, about 2,700 individuals claimed \$18.7 million in previously taxed income deductions, resulting in \$865,000 in revenue impact to the State in that year. However, these deductions were all attributable to individual taxpayers claiming the deduction for 1984-1986 PERA or 1986 DPSRS contributions, which were subject to tax at the time they were contributed. We lacked data on the number of estate and trust taxpayers who claimed the Previously Taxed Income Deduction and the total amount claimed by those taxpayers, as well as data on individuals who claimed the deduction for income other than 1984-1986 PERA or 1986 DPSRS contributions. However, Department staff reported that an estate or trust claiming this deduction or an individual claiming it for previously taxed income, other than a 1984-1986 PERA or 1986 DPSRS contribution, would be rare and, thus, would likely have little to no revenue impact in most years.

Additionally, unless the State changes the way it conforms to federal law regarding the timing of the taxation of income, most of the revenue impact of this deduction will eventually phase out since it typically only applies to employee contributions made to PERA from July 1, 1984 to December 31, 1986 and employee contributions made to DPSRS from January 1, 1986 to December 31, 1986. Since the last date that eligible contributions would have been made was about 34 years ago, it is likely that many of the employees who contributed during those years have already retired or will retire in the near future.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the deduction would result in individual, estate, and trust taxpayers being taxed twice at the state level on income that was previously taxed in Colorado, and is included in their federal taxable income. Specifically, state employees who made contributions to PERA from July 1, 1984, to December 31, 1986, and DPS employees who made contributions to DPSRS from January 1, 1986, to December 31, 1986, would be taxed twice on the amount contributed. In Tax Year 2018, this would have resulted in an increase of about \$865,000 in tax liability for about 2,700 taxpayers, which is an average of about \$300 per taxpayer. Additionally, although there are likely few taxpayers who claim the deduction for other types of previously taxed income, Department staff reported that it is advantageous to have the provision in statute in case there are any changes to state law that would change the timing of taxation of income or gains.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the statutes of the other 40 states (excluding Colorado) and the District of Columbia with a broad income tax and found that nine states, including Arizona, Georgia, Kansas, Maine, Massachusetts, Minnesota, Missouri, New York, and Virginia, along with the District of Columbia, have a similar deduction. However, states differ in the specific language used in their statutes, with six of the nine states and the District of Columbia having a broad deduction for any previously

taxed income that is very similar to Colorado's deduction and the others providing narrower exemptions.

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

We identified two similar income tax deductions available in the State:

- **PREVIOUSLY TAXED INCOME OR GAIN DEDUCTION FOR CORPORATIONS** [SECTION 39-22-304(3)(e), C.R.S.]—This deduction allows corporations to deduct from their income used for federal tax purposes 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, when calculating Colorado taxable income. The Office of the State Auditor evaluated this deduction in 2019 and found that it is likely not being used. The evaluation of this deduction is available in the September 2019 *Office of the State Auditor's Tax Expenditures Compilation Report*.
- **PENSION OR ANNUITY DEDUCTION FOR INDIVIDUALS** [SECTION 39-22-104(4)(f), C.R.S.]—This deduction allows individual taxpayers who are at least 55 years old to deduct up to \$20,000 in qualifying pension or annuity income from their federal taxable income when calculating their Colorado taxable income. Taxpayers who are at least 65 years old are allowed to deduct up to \$24,000. If a taxpayer's federally taxable pension or annuity income is less than \$20,000 (\$24,000 for taxpayers 65 and older), they do not need to use the Previously Taxed Income Deduction because all of their pension or annuity income is fully deductible under the Pension or Annuity Deduction for Individuals. However, if a 55-year-old taxpayer receives, for example, \$25,000 in PERA distributions and is entitled to a \$5,000 PERA deduction because they contributed \$5,000 to PERA between 1984 and 1986, the taxpayer is allowed to claim both the \$20,000 Pension or Annuity Deduction and \$5,000 Previously Taxed Income Deduction in the same tax year.

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

The Department was not able to provide us with data on the number of estates and trusts that claimed the Previously Taxed Income Deduction or the total amount claimed. Estates and trusts claim the deduction on Line 5 (subtractions from federal taxable income) of the Fiduciary Income Tax Return (Form DR 0105), which aggregates several deductions. Therefore, the Department of Revenue does not have data specific to this deduction for estates and trusts. Additionally, the Department was not able to provide us with data on individuals who claimed the Previously Taxed Income Deduction for eligible income other than 1984-1986 PERA or 1986 DPSRS contributions; the deduction for income other than 1984-1986 PERA or 1986 DPSRS contributions is reported on Line 19 (for other previously taxed income) of the Subtractions from Income Schedule (Form DR 0104AD), which aggregates several deductions.

To provide complete information on the deduction and its revenue impact, the Department would have to create new reporting lines on the Form DR 0105 and the Form DR 104AD, and then capture and house the data collected on those lines, which, according to the Department, would require additional resources (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). Department staff reported that estates and trusts claiming this deduction is likely rare. Department staff also indicated that they were not aware of any previously taxed income besides 1984-1986 PERA and 1986 DPSRS distributions that would currently qualify for the deduction since Colorado and federal tax law are generally aligned with regards to the timing of taxation of income. Therefore, it may not be worth the additional expense to amend the Form DR 0105 and Form DR 0104AD.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PREVIOUSLY TAXED INCOME DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Based on its operation and discussions with Department of Revenue staff, we considered a potential purpose: to reconcile differences between state and federal tax law and prevent the State from taxing the same income twice. We also developed a performance measure to evaluate its effectiveness. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY COULD CONSIDER WHETHER INDIVIDUAL, ESTATE, TRUST, AND CORPORATE TAXPAYERS WHO CLAIMED A CREDIT PURSUANT TO SECTION 1341 OF THE INTERNAL REVENUE CODE SHOULD BE ABLE TO CLAIM THE PREVIOUSLY TAXED INCOME DEDUCTION. For federal income tax purposes, Section 1341 applies "when a taxpayer properly reports an amount of income in one taxable year and later repays all or a portion of that same amount in a later taxable year because the taxpayer, in fact, did not have an unrestricted right to that income." The purpose of Section 1341 is essentially to put the taxpayer in the same economic position they would have been in had they not included the income that they later had to return in a previous year's gross income for tax purposes. An example of a transaction in which Section 1341 may apply is when someone accepts a signing bonus for accepting a job but later has to repay all or part of the bonus because they did not remain at the company for the required time stipulated in the contract. Section 1341 provides two options for resolving the situation: (1) a deduction for the amount of income that was previously

included in gross income or (2) a credit for the amount of tax that was previously paid on that income. A taxpayer may choose to take the credit rather than the deduction in a case in which the tax rate had changed and claiming a deduction for the income would not fully restore the taxpayer to the same economic position. For example, if an individual taxpayer included \$10,000 of income on their return that was taxed at the 32 percent rate, but in a subsequent year determined they did not have an unrestricted right to that income and deducted it against income that fell into the 24 percent bracket, they would have paid \$3,200 tax on the income but later received a deduction that would provide a reduction in tax of only \$2,400—\$800 less tax than was paid.

Colorado uses federal taxable income as the starting point for calculating Colorado taxable income. Therefore, if a taxpayer claimed a deduction for income previously included in their gross income, that deduction would flow through to the Colorado return for Colorado income tax purposes. However, if a taxpayer elected to claim a credit in lieu of a deduction, the credit does not flow through for Colorado income tax purposes. In prior years, the Department allowed individuals, estates, and trusts to use the Previously Taxed Income Deduction in cases where taxpayers had claimed a credit under Section 1341. However, the Department recently reviewed the statutory language of the Previously Taxed Income Deduction and determined that it does not support the allowance of a deduction in relation to credits claimed on a taxpayer's federal income tax return under Section 1341. Therefore, the General Assembly could consider whether taxpayers that claim Section 1341 credits should be allowed to claim the deduction and if so, amend statute accordingly. Further, because corporations are not eligible for the Previously Taxed Income Deduction, but also cannot claim a deduction at the state level when they claim Section 1341 credits, the General Assembly could also consider amending statute to allow them to claim a deduction when this occurs.

To the extent taxpayers claimed a deduction, this change would decrease state revenue; however, for individuals, estates, and trusts, it

appears that this use of the deduction, when the Department allowed it, was rare. For example, in 2016 and 2017, the Department identified about 10 claims in each year related to the Section 1341 credit for individuals, estates, and trusts. There is no data available on how many corporations would benefit from the state allowing a deduction or credit related to a Section 1341 credit.

Additionally, it appears this is a relatively common provision in other states with an income tax. We examined the statutes of the other 40 states (excluding Colorado) with a broad income tax and found that at least 16 states have a provision that specifically addresses Section 1341. Of those 16 states, we identified seven that apply the provision to all taxpayers, including corporations.