HB 20-1420

Legislative Council Staff

Nonpartisan Services for Colorado's Legislature

REVISED FISCAL NOTE

(replaces fiscal note dated June 12, 2020)

Drafting Number: LLS 20-1268
Prime Sponsors: Rep. Sirota; Gray
Sen. Moreno; Hansen

Date: June 13, 2020
Bill Status: Senate Third Reading
Fiscal Analyst: Greg Sobetski | 303-866-4105
Greg.Sobetski@state.co.us

Bill Topic: **ADJUST TAX EXPENDITURES FOR STATE EDUCATION FUND**

Summary of Fiscal Impact:

☒ State Revenue
☒ State Expenditure
☒ State Transfer
☐ TABOR Refund
☐ Local Government
☐ Statutory Public Entity

The bill makes changes to state income tax expenditures. It increases state revenue, on net, in FY 2020-21 and FY 2021-22 and reduces revenue on net beginning in FY 2022-23 on an ongoing basis. It also makes transfers from the General Fund to the State Education Fund for FY 2020-21 and FY 2021-22, and requires ongoing expenditures for administration.

Appropriation Summary: No appropriation is required.

Fiscal Note Status: This revised fiscal note reflects the revised bill.

Table 1
State Fiscal Impacts Under HB 20-1420*

		FY 2020-21	FY 2021-22	FY 2022-23	FY 2023-24
Revenue	General Fund	$94.1 million	$32.0 million	($34.3 million)	($58.0 million)
	Total	**$94.1 million**	**$32.0 million**	**($34.3 million)**	**($58.0 million)**
Expenditures	General Fund	-	$0.6 million	$0.4 million	$0.4 million
	Central. Approp.	-	$0.2 million	$0.2 million	$0.2 million
	Total	**-**	**$0.8 million**	**$0.6 million**	**$0.6 million**
	Total FTE	**-**	**8.5 FTE**	**8.5 FTE**	**8.5 FTE**
Transfers	General Fund	($113 million)	($23 million)	-	-
	SEF**	$113 million	$23 million	-	-
	Total	**$0**	**$0**	**-**	**-**
TABOR Refund		-	-	-	-

* *Totals may not sum due to rounding.*
** *State Education Fund.*

Summary of Legislation

The bill makes changes to state income tax expenditures, discussed below, and requires transfers from the General Fund to the State Education Fund (SEF) of $113 million on March 1, 2021, and $23 million on March 1, 2022.

Income taxes — CARES provisions. For tax year 2020, the bill requires additions to the taxable income of pass-through businesses and C corporations. For the purposes of computing state taxable income, these additions effectively reverse certain expanded income tax deductions allowed under the federal Coronavirus Aid, Relief, and Economic Security Act (CARES Act). These are as follows:

- pass-through businesses that claim an expanded federal net operating loss (NOL) deduction are required to add to their taxable income an amount equal to the portion of the deduction that is attributable to Section 2303 of the CARES Act;
- pass-through business owners that claim an excess business loss deduction are required to add to their taxable income an amount equal to the portion of the deduction that exceeded the limitation in the Tax Cuts and Jobs Act of 2017 (TCJA), as allowed by Section 2304 of the CARES Act;
- pass-through business owners and C corporations that claim a business interest income deduction are required to add to their taxable income an amount equal to the portion of the deduction that exceeded the limitation in the TCJA, as allowed by Section 2306 of the CARES Act.

The bill also requires that NOL deductions for 2018 and later tax years remain limited by provisions in the TCJA that had been relaxed in the CARES Act. More information on the relevant provisions of the CARES Act and subsequent Department of Revenue (DOR) rulemaking related thereto can be found in the Background section of this fiscal note.

Income taxes — qualified business income. For 2021 and 2022, the bill requires pass-through business owners who claim a federal qualified business income deduction, as allowed under the TCJA, to add back the amount of the deduction for the purposes of computing their state taxable income, if their adjusted gross income (AGI) exceeds $500,000 (for single filers) or $1,000,000 (for married taxpayers filing jointly). Taxpayers who report farm income on their federal tax return are exempt from the requirement to add back this deduction.

Income taxes — earned income tax credit. Under current law, the Colorado earned income tax credit (EITC) is allowed to taxpayers who are allowed the federal EITC, and is equal to 10 percent of the federal EITC. Beginning in tax year 2021, the bill extends the state EITC to taxpayers who would otherwise qualify for the federal EITC but who are disqualified from doing so because they, their spouse, or one or their dependents does not have a valid social security number. Beginning in tax year 2022, the bill increases the state EITC to 15 percent of the federal EITC.

Background

Taxable income. Colorado taxable income is equal to federal taxable income as modified in state law. Changes to federal taxable income by default change Colorado taxable income, unless state law or rule exists to preclude or alter the change.

CARES Act. The federal CARES Act became law on March 27, 2020. Among other provisions, the CARES Act made the following tax policy changes that are addressed in this bill:

- Section 2303 of the CARES Act allows NOLs arising in 2018 through 2020 to be carried back for up to five preceding tax years. Under preexisting federal law enacted in the TCJA, NOLs arising in 2018 and later years were restricted such that they could limit pre-NOL taxable income by up to 80 percent, rather than by up to 100 percent for NOLs arising in 2017 and earlier years. Section 2303 of the CARES Act delays implementation of the 80 percent limitation until 2021, allowing NOLs that arise in tax years 2018 through 2020 to be applied to reduce taxable income by up to 100 percent in those years. Finally, Section 2303 changes the base amount from which 80 percent is calculated, by allowing NOLs to reduce taxable income calculated before a taxpayer's NOL, qualified business income, and foreign-derived income deductions by up to 80 percent.

- Beginning in 2018, preexisting federal law enacted in the TCJA limited the amount by which deductions of pass-through business losses could reduce a taxpayer's non-business income, with the business loss exceeding the limit declared an excess business loss to be applied as an NOL deduction in a later tax year. Section 2304 of the CARES Act delays the TCJA excess business loss limitation until 2021, allowing deductions of unlimited business losses for tax years 2018 through 2020.

- Beginning in 2018, preexisting federal law enacted in the TCJA limited deductible business interest income to 30 percent, rather than the 50 percent limit that had applied for 2017 and earlier years. Section 2306 of the CARES Act delays the 30 percent limitation until 2021, allowing a 50 percent deduction for tax years 2018 through 2020.

The CARES Act provisions together reduce federal taxable income for tax years 2018 through 2020, allowing taxpayers who have already filed returns for 2018 and 2019 to file amended returns and claim income tax refunds for these years. For 2021 and future tax years, Section 2303 of the CARES Act reduces federal taxable income for taxpayers who are able to claim a larger NOL deduction as a result of modifications to the 80 percent limitation.

DOR emergency rules. On June 2, 2020, DOR adopted two emergency rules that together define "internal revenue code", for the purpose of determining federal taxable income, which is used to determine Colorado taxable income. Under the emergency rules, "internal revenue code" is defined to exclude federal statutory changes enacted after the end of a tax year. Pursuant to this change, DOR is expected to disallow amended returns filed to reduce taxable income for tax years 2018 and 2019 under the CARES Act. Accordingly, under current law and rule, the above provisions of the CARES Act are not expected to decrease state revenue for tax years 2018 or 2019.

Qualified business income deduction. The TCJA allows a federal income tax deduction for qualified business income for tax years 2018 through 2025. Taxpayers who earn income from ownership of some sole proprietorships, partnerships, limited liability corporations treated as sole proprietorships or partnerships for tax purposes, and S corporations ("pass-through businesses") are able to deduct 20 percent of such income when calculating their federal taxable income. For taxpayers whose income exceeds an inflation-adjusted threshold in federal law, additional limitations apply concerning the nature of the business and the amount it pays in wages. For tax year 2020, the threshold is $163,300 for single filers or $326,600 for joint filers.

Federal and state earned income tax credits. The federal EITC is available for taxpayers with earned income, such as income from wages or salaries, disability benefits received prior to the minimum retirement age, and some business income, whose earned income and AGI both fall below thresholds set in federal law. Thresholds depend on a taxpayer's filing status and number of qualifying children. For example, for 2020, a taxpayer filing singly or as a head of household is able to claim the credit if their income falls below $15,820 with no children, $41,756 with one child, $47,440 with two children, or $50,954 with three or more children. Benefits likewise depend on a taxpayer's AGI, filing status, and number of qualifying children. For 2020, the maximum credit amount ranges from $538 for taxpayers with no children to $6,660 for taxpayers with three or more children. A taxpayer and the spouse and/or dependents listed on their tax return must have a valid social security number in order to claim the federal EITC.

Under current law, Colorado taxpayers are able to claim a refundable state EITC equal to 10 percent of their federal EITC. A Colorado taxpayer must qualify for the federal EITC in order to claim the state EITC, meaning that they must also have a valid social security number.

Assumptions

Current law. This fiscal note presents the fiscal impact of the bill relative to current law. For the purposes of this fiscal note, current law includes the emergency rules adopted by DOR governing the state's administration of expanded federal income tax deductions in the CARES Act. To the extent that the bill changes statute to match DOR's administration of the CARES Act, it is treated as a codification of current practice with no new discrete fiscal impact.

Economic forecast. All revenue estimates assume future economic activity consistent with the May 2020 Legislative Council Staff forecast update.

State Revenue

The bill is expected to increase General Fund revenue by $94.1 million in FY 2020-21 and $32.0 million in FY 2021-22, and to decrease General Fund revenue by $34.3 million in FY 2022-23 and $58.0 million in FY 2023-24 and subsequent years. Revenue impacts are presented in Table 2 and discussed below. The bill affects income tax revenue, which is subject to TABOR.

Table 2
Revenue Impacts through FY 2022-22 Under HB 20-1420*

	FY 2020-21**	FY 2021-22	FY 2022-23	FY 2022-23
Income Tax Provisions				
CARES Section 2303	$5.0 million	***	***	***
CARES Section 2304	$72.8 million	$17.7 million	$0	$0
CARES Section 2306	$2.0 million	$5.4 million	$0	$0
Qualified Business Income	$19.5 million	$43.2 million	$23.7 million	$0
EITC - Expanded Eligibility	($5.2 million)	($13.1 million)	($15.7 million)	($15.7 million)
EITC - Additional Credit	-	($21.1 million)	($42.3 million)	($42.3 million)
Total	**$94.1 million**	**$32.0 million**	**($34.3 million)**	**($58.0 million)**

* *Totals may not sum due to rounding.*
** *Values shown for FY 2020-21 include impacts of the bill's CARES-related provisions that may arise in FY 2019-20 on an accrual accounting basis depending on executive branch accrual accounting. Any FY 2019-20 impacts are assumed to affect the beginning General Fund balance for FY 2020-21.*
*** *Indeterminate revenue increase, see discussion below.*

CARES provisions. Table 2 presents expected revenue increases from provisions in the bill that reverse revenue decreases that would otherwise be expected for tax year 2020 under the CARES Act. Relative to the estimates shown in Table 2, the May 2020 LCS forecast assumed larger decreases especially in relation to CARES Section 2303, concerning NOLs, and CARES Section 2306, concerning business interest income deductions. However, because the revenue decreases expected under these sections of the CARES Act were mostly attributable to retroactive modifications to taxable income for 2018 and 2019, they are assumed to be reversed pursuant to DOR emergency rules adopted on June 2, 2020, and are mostly excluded from this fiscal note.

For tax year 2021 and subsequent years, the bill increases state revenue because it reverses a provision in CARES Section 2303 that had relaxed the limitation on NOL deductions. Specifically, the CARES Act allows taxpayers to use an NOL carried forward from an earlier tax year to reduce taxable income by up to 80 percent of taxable income calculated before application of the NOL deduction, the qualified business income deduction, and the foreign-derived income deduction. This bill reverses the exclusion of the latter two deductions from this calculation, allowing taxpayers to reduce taxable income only by up to 80 percent of taxable income calculated before application of the NOL deduction. For taxpayers who take the qualified business income deduction and/or the foreign-derived income deduction, and who carry forward sufficiently large NOLs to reduce taxable income by more than 80 percent, the provision in this bill will increase revenue. Data and information are not currently available to calculate this impact, as the qualified business income deduction was first allowed in 2018 and no taxpayer-level information concerning the deduction has yet been shared by the federal government with the state government. The provision is assessed as causing an indeterminate ongoing revenue increase relative to what would otherwise have been expected under the CARES Act and may be updated as additional information becomes available.

Qualified business income deduction. Table 2 presents the revenue increase expected to result from the requirement that certain taxpayers add back their federal qualified business income deduction when calculating their Colorado taxable income for tax years 2021 and 2022. The revenue increases for FY 2020-21 and FY 2022-23 represent half-year impacts for tax years 2021 and 2022, respectively, on an accrual accounting basis. The bill requires the add back for taxpayers whose adjusted gross income exceeds $500,000 (for single filers) or $1,000,000 (for joint filers). Estimates are based on limited national level data for actual deductions claimed for tax year 2018.

Earned income tax credit. Table 2 presents revenue reductions expected to result from extending the state EITC to taxpayers without valid social security numbers beginning in tax year 2021 and from increasing the state EITC to 15 percent of the federal EITC beginning in tax year 2022. Estimates are based on state data for actual credits allowed for tax year 2017, as well as for state income tax filers using an individual taxpayer identification number (ITIN) in lieu of a social security number with incomes in the EITC eligibility range.

The estimates for FY 2020-21 and FY 2021-22 represent half-year impacts for the extension of the EITC to ITIN filers for tax year 2021 and for the expansion of the EITC to 15 percent of the federal credit for tax year 2022, respectively, on an accrual accounting basis. The impact of expanding the EITC to 15 percent of the federal EITC for filers without valid social security numbers is presented on the line labeled "Expanded Eligibility" in Table 2, and is not double counted on the line labeled "Additional Credit."

State Transfers

The bill transfers $113 million from the General Fund to the SEF in FY 2020-21 and $23 million from the General Fund to the SEF in FY 2021-22.

State Expenditures

The bill is expected to increase General Fund expenditures by the amounts shown in Table 3 and discussed below.

Table 3
Expenditures Under HB 20-1420

	FY 2020-21	FY 2021-22	FY 2022-23	FY 2023-24
Department of Revenue				
Personal Services	-	$424,441	$422,817	$422,817
Operating Expenses	-	$12,555	$11,475	$11,475
Capital Outlay Costs	-	$55,800	-	-
Computer Programming	-	$46,575	-	-
Computer and Related Testing	-	$52,716	$874	$874
Data Reporting	-	-	$4,608	$4,608
Tax Form Changes	-	$266	-	-
Centrally Appropriated Costs	-	$175,547	$175,401	$175,401
Total Cost	**-**	**$767,900**	**$615,175**	**$615,175**
Total FTE	**-**	**8.5 FTE**	**8.5 FTE**	**8.5 FTE**

State Education Fund. Revenue transferred to the SEF is assumed to be available for expenditure pursuant to future school finance acts. These expenditures are not identified in this fiscal note.

Department of Revenue. Expenditures for the department are expected to total $0.8 million in FY 2021-22 and $0.6 million in FY 2022-23 and FY 2023-24. Most expenditures are attributable to the addition of staff, including expenditures for personal services, operating expenses, capital outlay costs, and centrally appropriated costs.

DOR workload is expected to increase to process:

- additional EITC claims by taxpayers without valid social security numbers, requiring 6.1 FTE in FY 2021-22; and
- state income tax additions for federal qualified business income deductions, requiring 2.4 FTE in FY 2021-22.

Workload expected for DOR to process EITC claims and state income tax additions for federal qualified business income deductions is consistent with implementation of current law tax expenditures with similar caseload to that expected under the bill. Workload to process state income tax additions for federal qualified business income deductions will be required through FY 2023-24, and will not be required thereafter.

Other costs for the department are related to programming the department's GenTax software system; software and related user acceptance testing, performed by the department's Taxpayer Service Division and Systems Support Office; and, beginning in FY 2022-23, data reporting in the department's Office of Research and Analysis.

TABOR refunds. For FY 2020-21 and FY 2021-22, the bill increases state revenue subject to TABOR as noted in the State Revenue section of this fiscal note. The May 2020 LCS forecast anticipates that state revenue subject to TABOR will remain below the TABOR limit through at least FY 2021-22; therefore, the bill is not expected to affect TABOR refunds paid from the General Fund.

Effective Date

The bill takes effect upon signature of the Governor, or upon becoming law without his signature.

State and Local Government Contacts

Education	Information Technology	Law
Personnel	Regulatory Agencies	Revenue