HB 21-1002

Legislative Council Staff

Nonpartisan Services for Colorado's Legislature

Fiscal Note

Drafting Number:	LLS 21-0711	**Date:**	January 13, 2021
Prime Sponsors:	Rep. Weissman; Sirota Sen. Moreno; Hansen	**Bill Status:**	House Finance
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Bill Topic: **REDUCTIONS TO CERTAIN TAXPAYERS' INCOME TAX LIABILITY**

Summary of Fiscal Impact:

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

This bill creates a state income tax deduction, allowing taxpayers who carry back federal income tax deductions as allowed under the federal CARES Act to access corresponding state income tax benefits in 2021 and future tax years. It also broadens eligibility for the state earned income tax credit in 2020. It decreases state revenue and increases state expenditures on an ongoing basis.

Appropriation Summary: The bill requires appropriations to the Department of Revenue of $130,254 in the current FY 2020-21 and $96,905 in FY 2021-22.

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

Table 1
State Fiscal Impacts Under HB 21-1002

		Current Year FY 2020-21	Budget Year FY 2021-22	Out Year FY 2022-23
Revenue	General Fund	($24.3 million)	($24.0 million)	($21.5 million)
	Total	**($24.3 million)**	**($24.0 million)**	**($21.5 million)**
Expenditures	General Fund	$130,254	$96,905	$14,120
	Centrally Appropriated	$37,394	$9,849	-
	Total	**$167,648**	**$106,754**	**$14,120**
	FTE	**2.6 FTE**	**0.7 FTE**	**-**
Transfers		-	-	-
TABOR Refund		-	-	-

Summary of Legislation

The bill broadens taxpayer eligibility to claim the state earned income tax credit (EITC) for tax year 2020. For tax year 2021, the bill creates a state income tax deduction related to the federal and state treatment of certain tax policy changes in the federal Coronavirus Aid, Relief, and Economic Security Act (CARES Act). These provisions are described below.

EITC eligibility. Under current law enacted in House Bill 20-1420, eligibility for the state EITC will be broadened for tax year 2021 and later years. Taxpayers who themselves or whose dependents do not have a valid social security number will be able to claim the state EITC if they would otherwise be eligible to claim the federal and state EITCs for those years. This bill enacts this expansion one year earlier, so that taxpayers without valid social security numbers are able to claim the state EITC for tax year 2020.

State income tax deduction for CARES Act provisions. Prior to the CARES Act, taxpayers who incurred business losses generally carried forward federal income tax deductions in order to reduce their federal and state taxable income in future tax years. The CARES Act expanded some of these federal deductions, and allowed them to be carried back to reduce federal taxable income for past tax years. Under current federal and state law and rule, taxpayers who take advantage of these CARES Act provisions effectively lose the future state income tax benefits that would otherwise have been available to them.

For tax year 2021 only, the bill creates a state income tax deduction to address this effect. The total amount of the deduction is equal to:

- for any tax year ending before March 27, 2020, the amount by which the taxpayer's federal taxable income computed at the time of filing exceeded their revised federal taxable income computed after the application of the income tax policy changes in Sections 2303, 2304, 2306, and 2307 of the CARES Act, described in the Background section of this fiscal note; plus

- for tax years ending on or after March 27, 2020, and before January 1, 2021, the amount a taxpayer was required to add to their state taxable income pursuant to the CARES Act-related income tax additions enacted in HB 20-1420, described in the Background section of this fiscal note.

The deduction affects taxpayers who were able to accelerate federal income tax deductions as a result of the CARES Act, but who were not able to correspondingly accelerate their state income tax deductions due to the application of Department of Revenue rules and statute enacted in HB 20-1420. It has the impact of allowing taxpayers to apply these deductions at the state level in future tax years, similar to what would have been allowed had the CARES Act not become law.

The amount by which the state deduction may be used to reduce a taxpayer's taxable income is capped each year. Taxpayers whose deductible amount exceeds the cap may carry forward the excess to apply against taxable income in future years, until their entire deduction amount is exhausted.

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Background

Federal and state earned income tax credits. Colorado's EITC is based on the federal EITC, a refundable income tax credit available to taxpayers who work but who earn low incomes. The federal EITC requires taxpayers to have a valid social security number in order to qualify. Beginning for tax year 2021, HB 20-1420 expands the state EITC to include taxpayers who would otherwise qualify for the federal EITC but who do not themselves have, or whose dependents do not have, a valid social security number.

CARES Act — relevant provisions. Enacted on March 27, 2020, the CARES Act accelerated taxpayers' ability to apply certain tax deductions to reduce their federal taxable income and, thus, their federal income tax liability. The CARES Act raised preexisting caps on certain deductions and allowed some deductions to be carried back to earlier tax years. For example, taxpayers incurring losses would normally carry forward those losses to reduce their taxable income in subsequent years. The CARES Act allowed taxpayers to carry back losses to apply in prior years instead, allowing taxpayers to claim immediate refunds for taxes previously paid. This bill concerns four specific provisions of the CARES Act:

- **Section 2303**, which allowed net operating losses (NOLs) for 2018 through 2020 to be carried back for up to five preceding years, and increased the limitation on NOL deductions for 2018 through 2020 from 80 percent to 100 percent of pre-NOL taxable income;
- **Section 2304**, which removed a preexisting cap on the amount of a taxpayer's excess business loss deduction;
- **Section 2306**, which increased the cap on deductible business interest income from 30 percent to 50 percent of the taxpayer's adjusted taxable income; and
- **Section 2307**, which changed the depreciation formula used to calculate deductions for business investments in "qualified improvement property," essentially interior improvements to nonresidential buildings.

All of these provisions had retroactive impacts, allowing taxpayers to amend their federal income tax returns to claim increased deductions for completed tax years, thereby triggering tax refunds payable by the federal government to taxpayers.

State income tax impacts of federal CARES Act deductions. Colorado taxable income is based on federal taxable income, such that federal income tax deductions generally reduce Colorado taxable income and state income tax revenue. However, under current state law and rule, modifications made to federal taxable income under the CARES Act had no impact on Colorado taxable income for 2019 and earlier tax years, and deductions made pursuant to Sections 2303, 2304, and 2306 of the CARES Act were required to offset by state income tax additions for tax year 2020.

In June 2020, the Department of Revenue adopted two emergency rules that together define "internal revenue code" for the purpose of determining the state income tax base. Under the emergency rules, "internal revenue code" is defined to exclude federal statutory changes enacted after the end of a tax year. As a result of the rules, taxpayers who amended their federal returns for 2019 and earlier tax years in response to the CARES Act are not permitted to make corresponding changes to their state returns. Additionally, HB 20-1420 requires state income tax additions to offset deductions taken for tax year 2020 under Section 2303, 2304, and 2306 of the CARES Act.

Assumption

The annual deduction cap in the introduced bill has been left blank. This fiscal note assumes that the deduction will be limited to $300,000 per taxpayer in tax year 2021, and to the lesser of the outstanding deduction amount or $150,000 per taxpayer in 2022 and subsequent years. A lower limit would produce a smaller state revenue reduction in FY 2020-21 and FY 2021-22, pushing more of the bill's revenue impact into later years. A higher limit would produce a larger state revenue reduction in FY 2020-21 and FY 2021-22, and push less of the bill's revenue impact into later years.

State Revenue

The bill is expected to decrease General Fund revenue by $24.3 million in the current FY 2020-21, $24.0 million in FY 2021-22, and $21.5 million in FY 2022-23. The bill will decrease state revenue until income tax deductions that are carried forward have been exhausted. It is estimated that all deductions will be used by approximately FY 2030-31 and that the total revenue reduction to the state over this period will total about $210 million. The bill's revenue impacts are summarized in Table 2 and discussed below. The bill reduces income tax revenue, which is subject to TABOR.

Table 2
Revenue Impacts Under HB 21-1002

	FY 2020-21	FY 2021-22	FY 2022-23
Expanded Colorado EITC	($11.0 million)	-	-
State CARES Deduction	($13.3 million)	($24.0 million)	($21.5 million)
Total	**($24.3 million)**	**($24.0 million)**	**($21.5 million)**

Expanded EITC. Expanding access to the EITC in tax year 2020 is expected to decrease General Fund revenue by $11.0 million for FY 2020-21 only. This estimate reflects a full-year impact for tax year 2020, as none of the revenue impact can be accrued to the already closed FY 2019-20. The estimate reflects actual taxpayer data for tax year 2017, which show that about 35,300 taxpayers who filed their Colorado income tax return using an individual taxpayer identification number (ITIN) would have been eligible to claim the EITC if they had a valid social security number. The number of claimants and value of the credit were each grown consistent with observed rates of increase during past recessions. For tax year 2020, it is estimated that about 38,600 taxpayers will claim credits worth $11.0 million. To the extent that eligible filers do not claim the EITC, the revenue impact will be less than estimated. To the extent that taxpayers are induced to file tax returns in order to claim the EITC, the revenue impact will be greater than estimated.

This provision of the bill has no revenue impact for 2021 or future tax years, as the EITC will be available to taxpayers without social security numbers in those years under current law.

State CARES deduction. The revenue impact of the state income tax deduction in the bill is difficult to estimate due to data limitations. This fiscal note is based on the assumed state revenue impacts of the CARES Act that were used for the May 2020 LCS forecast update, prior to the Department of Revenue's emergency rulemaking and the passage of HB 20-1420. Because most taxpayers have not yet filed their 2020 income tax returns, no new data are available to estimate this impact.

The bill is estimated to allow taxpayers to deduct a total of $6.22 billion from their 2021 taxable income. If the entire amount were used to reduce taxpayers' income tax liability, the deduction would decrease state revenue by $283 million after application of the state's 4.55 percent income tax rate. However, actual deductions applied will be limited by taxpayers' taxable incomes and the deduction cap in the bill. To apportion the bill's revenue impact to 2021 and future tax years, this fiscal note relies on limited 2018 federal income tax data concerning the distribution of net operating loss deductions across taxable returns, and on the observed rate of application of net operating loss deductions carried forward after prior recessions. Based on prior recessions, it is estimated that approximately 30 percent of deductions will never be applied to reduce taxable incomes due to business closures that occur over the long period of carryforwards.

The revenue estimate for the current FY 2020-21 represents a half-year impact for tax year 2021 on an accrual accounting basis.

State Expenditures

The bill increases General Fund expenditures by $167,648 and 2.6 FTE in the current FY 2020-21, $106,754 and 0.7 FTE in FY 2021-22, and $14,120 in FY 2022-23 and subsequent fiscal years. These impacts are presented in Table 3 and described below.

Table 3
Expenditures Under HB 21-1002

	FY 2020-21	FY 2021-22	FY 2022-23
Department of Revenue			
Personal Services	$125,934	$31,484	-
Operating Expenses	$4,320	-	-
Computer Programming and Testing	-	$60,813	$9,512
Data Reporting	-	$4,608	$4,608
Centrally Appropriated Costs[1]	$37,394	$9,849	-
Total Cost	**$167,648**	**$106,754**	**$14,120**
Total FTE	**2.6 FTE**	**0.7 FTE**	**-**

[1]Centrally appropriated costs are not included in the bill's appropriation.

Expanded state EITC. Personal services, operating expenses, and centrally appropriated costs are for the addition of tax examiners in the Department of Revenue's taxpayer service section. Staff will be required to assist with processing claims by taxpayers who become eligible to claim the EITC for tax year 2020 under the bill. This fiscal note identifies expenses for 7.5 FTE, prorated for four months between February 2021 and June 2021. Personal service costs are split between the current FY 2020-21 and FY 2021-22 to account for the General Fund pay date shift. Payroll, operating, and capital outlay expenses beginning in July 2021 were identified in the fiscal note for HB 20-1420 and are not duplicated here as they arise under current law.

CARES deduction. Programming, testing, and data reporting costs identified beginning in FY 2021-22 are to create and maintain the state income tax deduction in the bill. Startup costs in FY 2021-22 are for programming the Department of Revenue's GenTax software system and testing by staff in the department's taxpayer service section and systems support office. Ongoing costs are for continued system maintenance and data reporting. Supervision and auditing of businesses who may claim the deduction will proceed as under current law, as the department will not perform additional business tax audits as a result of the bill. Any potential rulemaking for the deduction can be accomplished within existing appropriations to the Department of Revenue and the Department of Law.

Centrally appropriated costs. Pursuant to a Joint Budget Committee policy, certain costs associated with this bill are addressed through the annual budget process and centrally appropriated in the Long Bill or supplemental appropriations bills, rather than in this bill. These costs, which include employee insurance and supplemental employee retirement payments, are estimated to be $37,394 in the current FY 2020-21 and $9,849 in FY 2021-22.

TABOR refunds. The bill decreases income tax revenue, which is subject to TABOR. The December 2020 LCS forecast projects that state revenue will remain below the TABOR limit through at least FY 2022-23, and that the state will not be required to issue TABOR refunds through at least FY 2023-24. The bill does not change these expectations concerning refunds to taxpayers.

Technical Note

EITC timing. Under current law enacted in HB 20-1420, taxpayers without valid social security numbers will be able to claim the state EITC beginning for tax year 2021. The bill allows these taxpayers to claim the state EITC for the already-complete tax year 2020, for which tax returns are already being filed in advance of the April 15, 2021, due date.

In general, it is impossible for the Department of Revenue to create or expand a tax expenditure after completion of a tax year because computer programming and tax form changes are required to be finished by January 1. In this case, the department reports that it prospectively completed work during 2020 in anticipation of this bill. The fiscal note for HB 20-1420 identified required expenditures for the department to complete this work during FY 2021-22. This fiscal note assumes that the department accomplished the changes by shifting expenditures between the current FY 2020-21 and FY 2021-22. Total implementation expenditures to expand the EITC are not expected to change as a result of this bill, and this fiscal note does not identify a need for FY 2020-21 programming and form change costs because this work is already complete.

Taxpayers who become eligible to claim the state EITC for tax year 2020 as a result of this bill may in practice amend their 2020 returns during FY 2021-22. In such cases, a portion of the revenue reduction estimated for the current FY 2020-21 may actually occur during FY 2021-22.

Effective Date

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

State Appropriations

The bill requires General Fund appropriations to the Department of Revenue of $130,254 for the current FY 2020-21, with an allocation of 2.6 FTE, and $96,905 for FY 2021-22, with an allocation of 0.7 FTE.

State and Local Government Contacts

Information Technology	Law	Personnel	Revenue