

CORPORATE CONDEMNATION CAPITAL GAINS INCOME TAX DEDUCTION



EVALUATION SUMMARY

JULY 2020
2020-TE15

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Unknown, but likely minimal
NUMBER OF TAXPAYERS	Unknown
AVERAGE TAXPAYER BENEFIT	Unknown
IS IT MEETING ITS PURPOSE?	Yes, but it is likely used rarely

WHAT DOES THIS TAX EXPENDITURE DO?

The Corporate Condemnation Capital Gains Income Tax Deduction (Deduction) allows C-Corporations to deduct the gain from a sale of real or personal property under the following circumstances: (1) the buyer of the property initiates the transaction, and (2) the buyer had or could have obtained the power to condemn the property.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to review the scope of the Deduction to determine if it is meeting its intent. Specifically, the Deduction provides beneficiaries with more generous tax treatment than taxpayers who qualify for a federal deferral under Section 1033 of the Internal Revenue Code and excludes individual taxpayers, both of which are contrary to the stated statutory purpose.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute states that the purpose of the Deduction “is, for purposes of Colorado income tax, to accord a seller in a qualified sale the same treatment received by a taxpayer under [S]ection 1033 of the [I]nternal [R]evenue [C]ode relating to gains from involuntary conversion, even though said seller does not qualify under said [S]ection 1033 due to the absence of condemnation or the threat or imminence thereof and the buyer of the property purchased initiates the transaction.” [Section 39-22-304(3)(d)(III), C.R.S.]

WHAT DID THE EVALUATION FIND?

We found that this tax expenditure is meeting its purpose, but to a limited extent because it is likely used infrequently and will continue to be used infrequently in the future.

CORPORATE CONDEMNATION CAPITAL GAINS INCOME TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Corporate Condemnation Capital Gains Income Tax Deduction (Condemnation Deduction) [Section 39-22-304(3)(d), C.R.S.] allows C-Corporations to deduct the gain from a sale of real or personal property if the following conditions are met: (1) the buyer of the property initiates the transaction, and (2) the buyer had or could have obtained the power to condemn the property, but did not use this power. Such transactions would occur when an entity, with the power to condemn a property and force a sale under its eminent domain authority, approaches a property owner seeking to purchase the property.

This provision was established to expand, for state tax purposes, the eligibility requirements for a similar federal deduction. Specifically, United States Code, Title 26 - Internal Revenue, Section 1033 (Section 1033 of the Internal Revenue Code) allows corporations to defer capital gains in cases of involuntary conversions, including condemnations. Because Colorado uses federal taxable income as the starting point for calculating Colorado taxable income, taxpayers who claim this deferral for federal tax purposes, also receive its benefit for state tax purposes. However, for federal tax purposes the property owner has to have proof that the property was condemned or was under the imminent threat of condemnation. The Condemnation Deduction allows taxpayers to claim a deduction at the state level even if they cannot show that it was under imminent threat of condemnation as long as a buyer with the power to condemn the property initiated the transaction.

House Bill 77-1655 established the Condemnation Deduction, which became effective for tax years starting January 1, 1978. Between 1978 and 1987, the Condemnation Deduction was allowable for individuals and corporations. However, in 1987 the deduction for individuals was eliminated from statute as part of a broad revision and reenactment of all of what is now Title 39, Article 22, which includes the income tax sections of the Colorado Revised Statutes.

To claim the Condemnation Deduction, taxpayers include the amount of gain they received from a qualifying sale of property that was included in their federal taxable income on Line 13 (“Other Subtractions”) of their state C-Corporation Income Tax Return (Form DR 0112). Taxpayers then subtract this line from their federal taxable income to determine their Colorado taxable income.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute identifies corporations that realize gains from a sale of property to a buyer with the power to condemn the property, but that do not qualify for the federal deferral under Section 1033 of the Internal Revenue Code because there is not an actual or imminent threat of condemnation, as the beneficiaries of this tax expenditure.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute states that the purpose of the Condemnation Deduction “is, for purposes of Colorado income tax, to accord a seller in a qualified sale the same treatment received by a taxpayer under [S]ection 1033 of the [I]nternal [R]evenue [C]ode relating to gains from involuntary conversion, even though said seller does not qualify under said [S]ection 1033 due to the absence of condemnation or the threat or imminence thereof and the buyer of the property purchased initiates the transaction.” [Section 39-22-304(3)(d)(III), C.R.S.]

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

We found that this tax expenditure is meeting its purpose, but to a limited extent because it is likely used infrequently. 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 Condemnation Deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are C-Corporations using the Condemnation Deduction?*

RESULT: We were unable to confirm whether any taxpayers have claimed this deduction in recent years because the Department of Revenue does not collect data specific to the Condemnation Deduction. However, it appears likely that this deduction is used infrequently. We consulted with a Certified Public Accountant and a commercial real estate agent practicing in Colorado and neither had heard of the Condemnation Deduction. Although sales to government entities with the power to condemn occur in Colorado with some frequency, it appears rare for these sales to not qualify for the federal deferral under Section 1033 of the Internal Revenue Code. Specifically, when a condemning authority contacts a corporation seeking to purchase their property, in effect, there would typically be an imminent threat of condemnation for federal tax purposes since condemning authorities can almost always condemn the property under eminent domain through the court system. Therefore, it appears uncommon for corporations to have a need for the Condemnation Deduction because if the sale qualifies for a deferral of capital gains under Section 1033 of the Internal Revenue Code, then it would already be excluded from their federal taxable income, which is the starting point for determining Colorado taxable income, and they would not be able to use the Condemnation Deduction.

We spoke to two state entities that have the power to condemn property under eminent domain, the Colorado Department of Transportation (CDOT) and the Regional Transportation District (RTD). Both CDOT and RTD staff said that for most of the properties for which they initiate the purchase, they

purchase under imminent threat of condemnation because they can likely get a condemnation order in court if the property owner does not agree to sell the property voluntarily. However, RTD staff said that on rare occasions, entities with condemnation authority may purchase property in “voluntary sales.” These transactions are not under threat of condemnation; if the property owner does not agree to a price, then the transaction does not go through. Further, RTD said that in voluntary sales, condemnation is never discussed. Although the Condemnation Deduction could apply to this type of transaction, RTD staff said they were not aware of RTD purchasing property through this method and we were unable to determine whether any taxpayers have claimed the deduction. Therefore, it appears that the Condemnation Deduction may meet its purpose under some circumstances, though it is likely used only rarely.

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

The Condemnation Deduction likely has had little economic impact to the State since it seems that a situation where it could be used rarely occurs.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Since it appears that this deduction is used infrequently, if it were eliminated, it would likely impact only a small number of corporations, if any. However, if a corporation was unable to qualify for the federal deferral under Section 1033 of the Internal Revenue Code and would have otherwise qualified for the Condemnation Deduction, its state tax liability could increase substantially. Because the taxable gain on the sale of property is generally calculated as the difference between the price at which it was acquired and the sale price, taxpayers whose property has seen substantial appreciation in value since they originally purchased it would experience the largest potential increase in tax liability. For example, a taxpayer who purchased a property for \$1 million and later sold it to a government entity with condemning authority, but not under the threat of condemnation, for \$2 million would have to recognize an additional \$1 million in Colorado taxable income. This could increase their state tax liability by up to \$46,300, assuming they could not offset the gain through other tax expenditures.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any other states with a similar deduction to Colorado.

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

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

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

The Department of Revenue was not able to provide us with data to determine the extent to which any C-Corporations had 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 combines several deductions and cannot be disaggregated for analysis. To provide data necessary to 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 from that line in GenTax, its tax processing and information system, which, according to the Department of Revenue, 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 of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE SCOPE OF THE CONDEMNATION DEDUCTION TO DETERMINE WHETHER IT IS MEETING ITS INTENT. First, according to statute, the purpose of the Condemnation Deduction is to “accord a seller in a qualified sale the *same* [emphasis added] treatment received by a taxpayer under [S]ection 1033 of the internal revenue code relating to gains from involuntary conversion, even though said seller does not qualify under said [S]ection 1033 due to the absence of condemnation or

the threat or imminence thereof” [Section 39-22-304(3)(d), C.R.S.]. However, we found that the Condemnation Deduction likely provides corporations that use the Condemnation Deduction with more generous tax treatment for qualifying sales than taxpayers who claim the federal deduction under Section 1033 of the Internal Revenue Code. Specifically, taxpayers who qualify for a deferral under Section 1033 of the Internal Revenue Code must generally reinvest any capital gains from the sale into a similar property or a property that has a similar purpose and are liable for capital gains tax for a later sale of the replacement property. In contrast, taxpayers who claim the Condemnation Deduction are not required to reinvest the gain and would never be taxed on the capital gain they realized.

Second, under Section 1033 of the Internal Revenue Code, both individual and corporate taxpayers can qualify for the federal tax deferral in the case of a condemnation or imminent condemnation, but under Section 39-22-304(3)(d), C.R.S., only C-Corporations qualify for the Condemnation Deduction. Between 1978 and 1987, both individuals and C-Corporations could claim it; however, in 1987 as part of a revision and reenactment of all of the statutory sections currently included in Title 39, Article 22, the Condemnation Deduction was eliminated for individuals. We listened to the hearings from the 1987 revision and reenactment and there was no mention of why the Condemnation Deduction was eliminated for individuals.