

ALTERNATIVE INCOME TAX



JULY 2020
2020-TE20

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

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|----------------------------|------------------------------------------------------|
| YEAR ENACTED | 1969 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | \$70,268 or less (TAX YEAR 2018) |
| NUMBER OF TAXPAYERS | 76 |
| AVERAGE TAXPAYER BENEFIT | Unknown |
| IS IT MEETING ITS PURPOSE? | Yes, but not for businesses that file as individuals |

WHAT DOES THIS TAX EXPENDITURE DO?

The Alternative Income Tax [Sections 39-22-104(5) and 301(2), C.R.S.] allows individual and corporate taxpayers to elect to pay tax on 0.5 percent of their annual Colorado gross sales receipts, in lieu of paying the State's 4.63 percent income tax. It is optional for corporations and individuals that qualify to use it. To qualify, taxpayers must:

- Limit business activities in the state to making sales;
- Not own or rent real estate within Colorado; and
- Generate annual Colorado gross sales of \$100,000 or less.

WHAT DID THE EVALUATION FIND?

We found that this tax expenditure is meeting its purpose for corporate taxpayers, but its use is limited because few corporations qualify. For individuals we found that it is not meeting its purpose because there is not a process for them to use it.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The purpose of the Alternative Income Tax, as stated in House Bill 69-1530, was to “provide for an alternative tax to the income tax for certain taxpayers, consistent with the ‘Multistate Tax Compact.’” According to the Multistate Tax Commission, which was created under the Multistate Tax Compact, this provision was intended to benefit small businesses by offering a simplified method of calculating their tax due.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We identified two policy considerations related to the Alternative Income Tax:

- The General Assembly may want to review its eligibility requirements, in particular the \$100,000 limit on sales, which has not changed since 1969.
- Individual taxpayers cannot use the expenditure because the Department of Revenue has not established an administrative process or form for these taxpayers to claim it.

ALTERNATIVE INCOME TAX

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Alternative Income Tax [Sections 39-22-104(5) and 301(2), C.R.S.] allows individual and corporate taxpayers to elect to pay tax on 0.5 percent of their annual Colorado gross sales receipts, in lieu of paying the State's 4.63 percent income tax. This tax expenditure was established for corporate taxpayers in 1969 and was expanded to individuals in 1987.

The Alternative Income Tax is optional for corporations and individuals who qualify to use it. According to statute, to qualify, taxpayers must:

- Limit business activities in the state to making sales,
- Not own or rent real estate within Colorado; and
- Generate annual Colorado gross sales of \$100,000 or less.

We determined that the Alternative Income Tax functions as a tax expenditure because it likely reduces some qualifying taxpayers' tax liability and reduces state tax revenue. For example, a qualifying corporation with \$50,000 in gross sales receipts would pay \$250 ($\$50,000 \times 0.5$ percent) in taxes if it elected to use the exemption. If that corporation instead elected to pay the State's regular 4.63 percent income tax and had taxable income of over \$5,400 it would pay more in taxes (*calculated as: over \$5,400 x 4.63 percent = \$250*). Taxpayers' taxable income is typically less than gross sales, since it is generally established by subtracting business expenses and depreciation from gross sales. It is likely that some taxpayers can reduce their tax liability by using the Alternative Income Tax.

In order to claim the Alternative Income Tax, corporate taxpayers check a box (number 45) in the applicable section of the Colorado C-Corporation Income Tax Return (Form DR 0112). The corporation must enter its annual Colorado

gross receipts on line 18 of DR 0112, then calculate 0.5 percent tax on line 19, and enter “gross receipt tax” next to each of these two lines. According to state regulations [1 CCR 201-2, Rule 39-22-301(2)], the taxpayer must also attach a statement to the return that establishes their eligibility for the election as well as the computation of the tax.

According to the Department of Revenue there is no established form or procedure for individuals to use the Alternative Income Tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of this tax expenditure. Based on its eligibility requirements, we inferred that the intended beneficiaries are small businesses, filing as corporations or individuals, with operations in the state limited to making sales.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The purpose of the Alternative Income Tax, as stated in House Bill 69-1530, was to provide “for an alternative tax to the income tax for certain taxpayers, consistent with the ‘Multistate Tax Compact.’” The Multistate Tax Compact (MTC), which became effective in 1967, is an advisory compact among 16 member states (including Colorado) with the purposes of promoting uniformity of tax systems and facilitating taxpayer convenience and compliance. A broad range of uniform tax provisions have been established under the MTC, including the Alternative Income Tax. According to staff from the Multistate Tax Commission, which was created under the MTC, this provision was intended to benefit small businesses by offering a simplified method of calculating their tax due. We considered this to be the intended purpose of this tax expenditure.

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

Overall, we found that the Alternative Income Tax is likely meeting its purpose to a limited extent for corporate taxpayers, but not for individuals because there

is not an administrative process for them to use it, as discussed further in this section.

Statute does not provide a quantifiable performance measure for this tax expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the tax expenditure is meeting its purpose:

PERFORMANCE MEASURE: *To what extent do eligible corporations and individuals opt to take the Alternative Income Tax?*

RESULT: We determined that the Alternative Income Tax is used by a relatively small number of corporations. Specifically, based on Department of Revenue data, 76 corporations used it for Tax Year 2018 (the most recent year that data were available).

The Alternative Income Tax is likely used infrequently because few corporations meet its eligibility requirements and have sufficient business activity in the state to be required to file any form of income tax. Department of Revenue regulations [1 CCR 201-2, Rule 39-22-301.1(2)] require businesses to pay income taxes if they meet any of the following criteria during the tax year:

- Own at least \$50,000 worth of property;
- Have at least \$50,000 of payroll;
- Make at least \$500,000 of sales; or
- Have more than 25 percent of its total property, total payroll, or total sales occur in the state.

Because a company must generate no more than \$100,000 in annual Colorado gross sales to take the Alternative Income Tax, many corporations that may otherwise be eligible lack sufficient sales to have a need to use it, since they must have sales of over \$500,000 to be subject to income tax in the state under Department of Revenue regulations. However, according to Department of Revenue staff, corporate taxpayers could claim the Alternative Income Tax if they have no property or payroll in Colorado and make less than \$100,000 of

sales in the state, but more than 25 percent of their total sales occur in Colorado. Another situation when the Alternative Income Tax could be claimed is, if corporations have more than \$50,000 in payroll, but do not rent or own property, while having less than \$100,000 in sales in the state.

We determined that the Alternative Income Tax is not currently used by businesses that file as individuals because the Department of Revenue has not implemented an administrative mechanism or procedures to allow eligible individuals to use it.

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

We estimate that the Alternative Income Tax had a maximum revenue impact to the State of \$70,268 in Tax Year 2018. To arrive at this estimate, we used data from the Department of Revenue showing that corporations choosing the Alternative Income Tax for Corporations paid a combined total of \$8,507 in taxes in 2018. By dividing the total tax paid (\$8,507) by 0.5 percent, we calculated that these taxpayers had \$1,701,400 total gross receipts during 2018. Multiplying the total gross receipts amount by the income tax rate of 4.63 percent resulted in \$78,775 in income taxes that would have been owed. We then subtracted the tax paid (\$8,507) from the estimated income tax (\$78,775) to arrive at our estimate. However, this method likely overestimates the true revenue impact by assuming taxpayers do not claim any deductions, which would be subtracted from their gross sales receipts when calculating taxable income, and could substantially reduce their tax liability and the amount of income tax owed.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Alternative Income Tax was eliminated, taxpayers who have previously used this tax expenditure would have to calculate their taxes based on 4.63 percent of their net income rather than on 0.5 percent of their annual gross sales receipts. This would likely increase some corporations' tax liability. Further, eliminating the Alternative Income Tax option might make filing income taxes more difficult for corporations that currently use this option.

Specifically, for a C-corporation to calculate its corporate income tax liability in Colorado, it must first calculate its Colorado net income, which is its federal taxable income modified by any additions or subtractions required or permitted under Colorado law. Further, businesses operating in multiple states would also need to apportion and allocate their income across Colorado and the other states they earned income within, as prescribed by Colorado law.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We reviewed the laws of MTC member states and identified five other states: Alabama, Hawaii, Idaho, Montana, and New Mexico with an alternative income tax. Although the provision's eligibility requirements are similar to Colorado in all five of these states, the tax rates vary from 0.25 percent in Alabama to 1 percent in Idaho. New Mexico, the only bordering state with a similar provision, taxes gross receipts at 0.75 percent.

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

There are no similar expenditures or programs in the state.

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

There were no data constraints that impacted our ability to evaluate the tax expenditure.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE ELIGIBILITY REQUIREMENTS FOR THE ALTERNATIVE INCOME TAX. As discussed, only 76 taxpayers used the Alternative Income Tax in Tax Year 2018. Based on our review of this tax expenditure's eligibility requirements and Department of Revenue regulations, which establish the criteria for businesses to pay income taxes in Colorado, few businesses would both be required to pay income taxes in Colorado and meet the eligibility requirements for the Alternative Income Tax. In particular, the requirement that businesses have \$100,000 or less in sales

in the state likely limits its usage, since Department of Revenue regulations require that businesses have more than \$500,000 in sales in the state to be liable for paying income taxes, unless they have more than \$50,000 in property or payroll in the state or more than 25 percent of their total sales, property, or payroll in the state. Because the \$100,000 limit on sales has remained unchanged since 1969, when the provision was established, due to inflation, it is now effectively limited to a smaller scale of sales than in 1969. According to U.S. Bureau of Labor Statistics data, adjusting for inflation, \$100,000 in 1969 would be equivalent to about \$700,000 in 2020.

THE GENERAL ASSEMBLY MAY WISH TO DIRECT THE DEPARTMENT OF REVENUE TO ESTABLISH AN ADMINISTRATIVE PROCESS FOR INDIVIDUAL TAXPAYERS TO USE THE ALTERNATIVE INCOME TAX. Although Section 39-22-104(5), C.R.S., makes taxpayers who file as individuals eligible for the expenditure under the same criteria as corporations, there is no form for individual taxpayers to claim the election and the Department of Revenue has not established any other process or guidance for individual taxpayers who wish to use it. It is unclear how many individual taxpayers would use this tax expenditure if a process was established for them to claim it; however, because of the narrow eligibility requirements discussed above, it is likely that few businesses that file as individuals would claim it. Establishing a form or amending an additional form for individuals to use and capturing this information in GenTax, the Department's tax processing and information system, would require the expenditure of resources at the Department of Revenue (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).