Deduction of Wages and Salaries Due to IRC 280C

OFFICE OF THE STATE AUDITOR
C O L O R A D O

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The Deduction for Wages and Salaries Due to Internal Revenue Code Section 280C (IRC 280C Deduction) allows businesses that cannot deduct wage and salary expenses for federal tax purposes due to IRC 280C to deduct these wage and salary expenses from their state taxable income. IRC 280C prevents taxpayers from deducting expenses that they use to qualify for several federal tax credits from federal taxable income so that they will not receive a double benefit at the federal level. Colorado uses federal taxable income as the basis for determining Colorado taxable income, but does not offer similar credits, so businesses that cannot deduct expenses under IRC 280C have a higher state tax liability if the expenses are not deductible at the state level.

We were unable to assess the extent to which eligible businesses claim the deduction because data is not available. According to Colorado Department of Revenue (Department) guidance, taxpayers claim the IRC 280C Deduction under the "Other Subtractions" line on the appropriate business type tax form, which is aggregated with several other types of deductions, so data specific to the deduction were not available for our analysis. However, Colorado CPA's we contacted indicated that they are aware of the deduction and have clients that use it.

Some types of businesses are not able to claim the deduction, even though they can claim a federal tax credit. The IRC 280C Deduction may only be claimed by C- and S-corporations, so some business types qualify for federal tax credits referenced by IRC 280C but are not allowed to claim Colorado's deduction.

The IRC 280C Deduction allows businesses to deduct some, but not all, of the expenses for which they receive a federal credit. Since the enactment of the state IRC 280C Deduction, IRC 280C now references additional federal tax credits that cover additional expenses besides wages and salaries. As a result, there are expenses for which businesses can claim credits that they may not deduct from their federal taxable income, but are also not deductible from their state taxable income.

Policy Considerations

The General Assembly could consider expanding the IRC 280C Deduction to more business entities that qualify for federal tax credits and including more types of expenses that are associated with federal tax credits referenced by IRC 280C in addition to wages and salaries.

Tax Type:	**Income**	Year Enacted:	**1979**
Expenditure Type:	**Deduction**	Repeal/Expiration Date:	**None**
Statutory Citation:	**Section 39-22-304(3)(i), C.R.S.**	Revenue Impact (2020):	**Unknown**

Purpose given in statute or enacting legislation? **No**

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Background

Businesses typically deduct expenses when filing their federal income taxes; however, businesses that incur expenses that qualify for federal tax credits referenced by IRC 280C [26 USC 280C] may not deduct those same expenses from their federal taxable income because they are receiving a credit instead. Colorado uses federal taxable income as the basis for determining Colorado taxable income, so businesses that claim federal credits cannot deduct these same expenses, and therefore will have a higher state taxable income if the expenses are not deductible at the state level.

The Deduction for Wages and Salaries Due to Internal Revenue Code Section 280C (IRC 280C Deduction) [Section 39-22-304(3)(i), C.R.S.] allows businesses that cannot deduct wage and salary expenses for federal tax purposes due to IRC 280C to deduct these wage and salary expenses from their state taxable income.

The enactment of IRC 280C in 1977 unintentionally led to an increase in Colorado tax liability for businesses receiving federal tax credits. This occurred because IRC 280C restricts businesses from deducting expenses they use to claim certain federal credits from their federal taxable income in order to prevent taxpayers from receiving a double benefit at the federal level (i.e., a credit and a deduction). Similar credits are not available at the state level, but Colorado uses federal taxable income as the starting point for calculating Colorado taxable income—in effect transferring the federal restriction on deductions to Colorado. As a result, businesses that claimed federal credits referenced by IRC 280C to decrease their federal tax liability had an increased Colorado taxable income and tax liability, with no offsetting state level deduction or credit. In 1979, the General Assembly created the IRC 280C Deduction to address this issue and allow businesses to deduct wage and salary expenses from their state taxable income that were disallowed from being deducted when calculating federal taxable income.

The IRC 280C Deduction may be claimed by C-corporations and S-corporations. C-corporations are subject to federal and state income taxes at the entity level. S-corporations are also subject to income tax, with income passing through to each shareholder's pro rata share ownership of the company. Individuals, estates, and certain trusts may be shareholders in an S-corporation. For federal tax purposes, Limited Liability Companies (LLCs) may elect to be either a C- or S-corporation and therefore claim the IRC 280C Deduction.

We inferred that the purpose of the IRC 280C Deduction is to offset businesses' higher state tax liability due to expenses which are normally deductible not being deductible because the business claimed federal credits. We inferred this purpose after reviewing federal Internal Revenue Code, state statutes, the legislative history of the deduction, and similar policies in other states. This is a common structural provision of states that use federal taxable income as the basis for determining state taxable income. Statute does not provide performance measures, so we developed the following performance measures to evaluate the deduction:

- To what extent is the deduction being claimed by eligible businesses receiving federal tax credits?
- To what extent are businesses that receive the applicable federal credits able to deduct expenses for state tax purposes that are not deductible at the federal level under IRC 280C?

Evaluation Results

We were unable to assess the extent to which eligible businesses claim the deduction because data is not available; however, stakeholders appear to be aware of and using the deduction. According to Department of Revenue (Department) guidance, taxpayers claim the IRC 280C Deduction under "Other Subtractions" on the appropriate business type tax form and aggregate the amount claimed for the IRC 280C Deduction with several other types of deductions. As a result, the amount claimed for the IRC 280C Deduction cannot be separated from other deductions claimed on the same line. For example, C-corporations claimed a total of $44.4 million in Other Subtractions in 2020, but we were unable to determine what portion was due to the IRC 280C Deduction. S-corporations that file their taxes at the entity level, or that pass through their income to their shareholders, also report the subtraction under the aggregated subtractions line on the appropriate Department tax forms. Additionally, while the U.S. Department of the Treasury reports on the use of the credits referenced under IRC 280C, it does not break them out by state, so we could not estimate the amount of credits that would potentially be eligible for the Deduction at the state level. Instead, we surveyed members of the Colorado Society of CPAs to determine whether eligible businesses are claiming the Deduction. We received responses from seven CPAs who all said they were familiar with the Deduction and have clients that use it.

Some types of businesses are not able to claim the deduction, even though they can claim a federal tax credit and are not allowed to deduct those related expenses from their federal taxable income. The IRC 280C Deduction may only be claimed by C- and S-corporations, so some business types qualify for federal tax credits referenced by IRC 280C but are not allowed to claim Colorado's deduction. The types of businesses that may qualify for federal tax credits referenced by IRC 280C varies depending on the credit. For instance, cooperatives and partnerships may claim the federal Work Opportunity Credit for salaries and wages, which is a credit referenced by IRC 280C, but are not eligible to claim the state level IRC 280C Deduction. As a result, some businesses, such as C- and S-corporations would be able to take the deduction, but others would have to pay state income tax on the salaries and wages they could not deduct on their federal taxes because they claimed a federal credit and the state deduction is not available to them.

The IRC 280C Deduction allows businesses to deduct some, but not all, of the expenses for which they receive a federal credit. When the deduction was created, the applicable federal credits only covered wage and salary expenses; so at the time, the state deduction—which is limited to wage and salary expenses—would have covered all of the expenses that were not deductible from federal taxable income under IRC 280C. However, since the enactment of the state IRC 280C Deduction, IRC 280C has been amended several times and now references additional federal tax credits that cover expenses besides wages and salaries. As a result, there are expenses that businesses can claim credits for that they may not deduct from their federal taxable income, but are also not deductible from their state taxable income. Exhibit 1 shows all federal tax credits referenced in IRC 280C and whether the credits allow qualifying expenses that are deductible for state tax purposes provided by the IRC 280C Deduction. As shown, not all credits cover salary and wage expenses, and some credits allow expenses that include wages and salaries, as well as additional expenses that the IRC 280C Deduction does not allow. Since the IRC 280C Deduction only allows the deduction of wage and salary expenses, businesses receiving tax credits that allow other expenses would have a higher state tax liability because they cannot deduct those expenses.

Exhibit 1
Colorado Allowance of Deduction of Expenses for Federal Tax Credits Referenced by IRC 280C

All expenses that qualify for the Credit are for wages and salaries, which are deductible at the state level. This includes:
Employer Wage Credit for Employees Who Are Active Duty Members of the Uniformed Services[1]
Employer Credit for Paid Family and Medical Leave[2]
Empowerment Zone Employment Credit[3]
Work Opportunity Credit[4]
Some expenses that qualify for the Credit are not wages and salaries, and are not deductible at the state level. This includes:
Qualified Clinical Testing Expenses for Certain Drugs Credit[5] Supplies and computers used in clinical testing are not deductible.
Credit for Increasing Research Activities[6] Supplies and computers used in conducting research are not deductible.
No expenses that qualify for the Credit are deductible at the state level. This includes:
Credit for Employee Health Insurance Expenses of Small Employers[7] Non-elective contribution amounts made on behalf of employees for premiums for qualified health plans are not deductible.

Source: Colorado Office of the State Auditor analysis of federal statutes [26 USC 280C] and:
[1] 26 USC 45P | [2] 26 USC 45S | [3] 26 USC 1396 | [4] 26 USC 51 | [5] 26 USC 45C | [6] 26 USC 41 | [7] 26 USC 45R

Policy Considerations

In our previous evaluation on the IRC 280C Deduction, published in April 2019, we included two policy considerations, which we repeat in this report. To better align the IRC 280C Deduction with the credits currently referenced by IRC 280C, the General Assembly can consider two policy changes.

The General Assembly could consider expanding the IRC 280C Deduction to more business entities that qualify for federal tax credits under IRC 280C. Currently, individuals (including those operating as sole proprietorships), estates, trusts, LLCs (not electing to be either a C- or S-corporation), and partnerships cannot claim the deduction despite being able to claim federal tax credits referenced by IRC 280C. The General Assembly could allow specific entities that are not currently eligible for the deduction to modify their federal taxable income under the corporate income tax statutes, which includes this deduction, similar to how S-corporations are allowed to according to statute [Sections 39-22-322 and 323, C.R.S.]. Alternatively, potential statutory language could allow all entities that claim federal tax credits referenced by IRC 280C to receive the IRC 280C Deduction specifically.

Expanding the types of businesses entities could have two effects. On one hand, it would help all entities that receive federal credits referenced by IRC 280C mitigate the impact of increased state tax liability as a result of not being allowed to deduct expenses as allowed ordinarily. On the other hand, allowing more businesses entities to deduct these expenses may increase the total state revenue impact associated with the IRC 280C Deduction. However, because there is no state data on the current use of the federal credits and the IRC 280C Deduction, we could not estimate the impact this would have on state revenue or businesses.

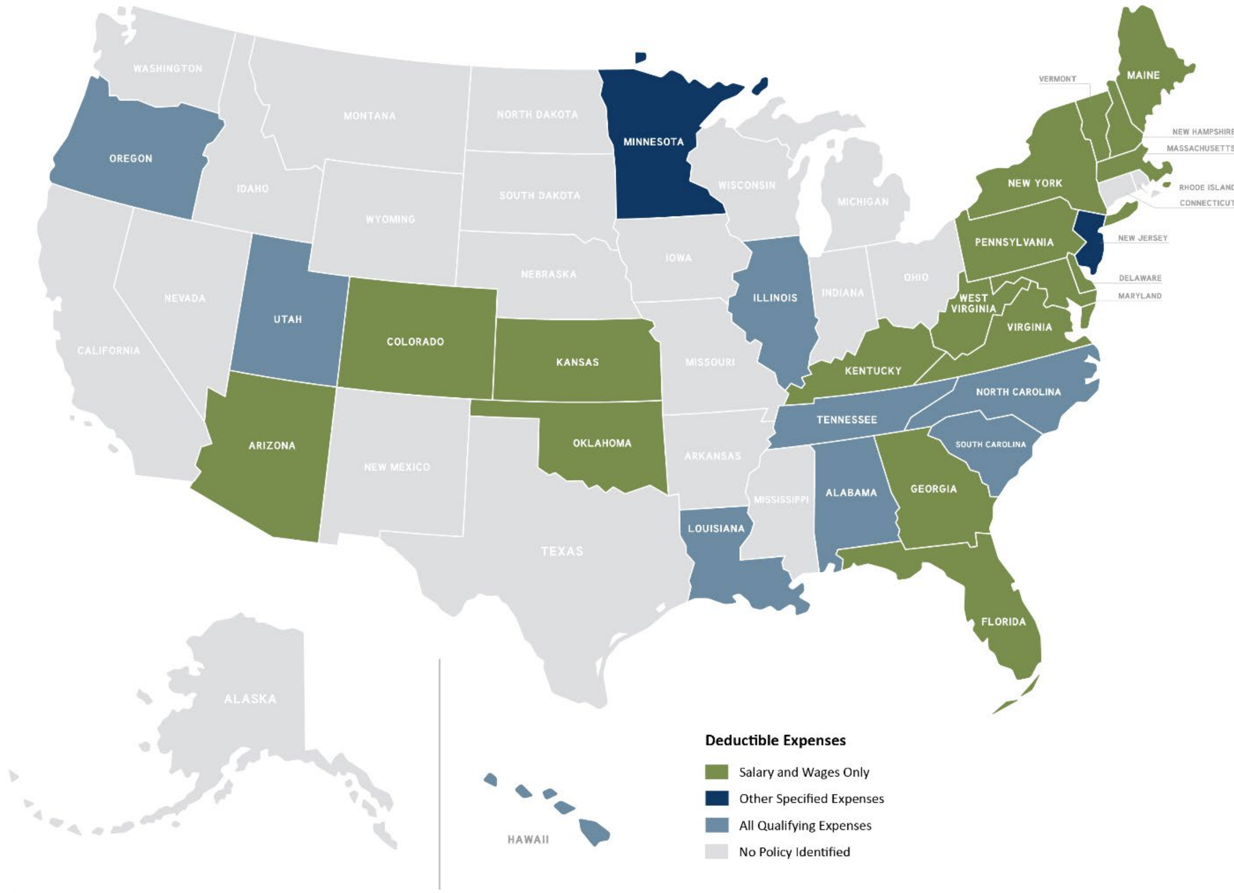
The General Assembly could consider including more types of expenses that are associated with federal tax credits referenced by IRC 280C in addition to wages and salaries. As shown above in Exhibit 1, the IRC 280C Deduction only reduces state tax liability to companies receiving federal tax credits for wage and salary expenses. However, all expenses associated with federal tax credits referenced by the section are disallowed from being deducted on a businesses' federal tax returns. For example, that means that a company receiving the Credit for Increasing Research Activities could only deduct wage and salary expenses used to qualify for the credit for state tax purposes and not the other expenses that they used for the federal credit, such as supplies or computers used in research activities. For any credit that a business claims with expenses other than wages and salaries, the effect would be a higher state tax liability.

Research into other states' policies shows there are other approaches the General Assembly could take if it desires to offset higher state tax liability for all federal credits referenced by IRC 280C. Exhibit 2 shows 16 states have policies similar to Colorado and allow businesses to deduct wage and salary expenses only. However, other states offer two alternative policy approaches:

- **Allow expenses associated with specific credits to be deductible**: A state may target specific federal credits and allow their associated expenses which are not deductible to become deductible when determining state taxable income. For instance, two states, Minnesota and New Jersey allow expenses associated with the Credit for Increasing Research Activities to be deducted.

- **Allow all expenses to be deductible**. IRC 280C references seven different tax credits with various expenses required to calculate the amount of credit a business can receive. In recognition that the expenses used to calculate this amount are "ordinary and necessary," and thus typically deductible, a total of nine states have allowed all qualifying expenses to be deductible for state tax purposes. North Carolina is an example of a state with this policy and allows a deduction for an ordinary and necessary business expense if the expense was required to be reduced or was not allowed under the Internal Revenue Code because the corporation claimed a federal tax credit in lieu of a deduction. [N.C. Gen. Stat. 105-130.5(b)(11)].

Exhibit 2
State That Have Policies Allowing C-Corporations to Deduct Certain Expenses due to IRC 280C



Source: State Auditor analysis of relevant state statutes and Bloomberg Tax Research.

Either one of these policy approaches would expand the types of expenses that can be deducted for state tax purposes, but would also increase the state revenue impact of the IRC 280C Deduction. However, we could not analyze the impact these state policies would have on state revenue or businesses because there is no state data on the current use of the federal credits and the IRC 280C Deduction. We did review publicly available data from other states' tax expenditure evaluations to see comparable revenue impacts and found that most states are like Colorado and report their equivalent deduction on a non-itemized line. We found that three states—Minnesota, New York, and West Virginia—report their deduction on itemized lines. Minnesota allows businesses to deduct expenses related to research and development (instead of wages and salaries) and reported a total fiscal impact of $4.2 million in Fiscal Year 2022. New York showed a fiscal impact for wage and salary deductions of $7 million as of Fiscal Year 2017. Finally, West Virginia also allows businesses to deduct wage and salary expenses for the Work Opportunity Credit, but only gave an estimated fiscal impact value of $400,000 annually.

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