

DEDUCTIONS FOR ASSETS HAVING A HIGHER COLORADO ADJUSTED BASIS THAN FEDERAL ADJUSTED BASIS EVALUATION SUMMARY



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2019-TE18

THESE EVALUATIONS WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

	DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS	DEDUCTION FOR CORPORATIONS
YEAR ENACTED	1964	1964
REPEAL/ EXPIRATION DATE	None	None
REVENUE IMPACT	Minimal	Minimal
NUMBER OF TAXPAYERS	Unable to determine	Unable to determine
AVERAGE TAXPAYER BENEFIT	Unable to determine	Unable to determine
IS IT MEETING ITS PURPOSE?	Yes, but it is rarely used	Yes, but it is rarely used

WHAT DO THESE TAX EXPENDITURES DO?

These deductions allow all taxpayers to subtract from their federal taxable income when calculating Colorado taxable income, the portion of any gain or loss from the sale or other disposition of property having a higher adjusted basis for Colorado income tax purposes than for federal income tax purposes.

WHAT DID THE EVALUATION FIND?

Due to their age and qualifications, it appears that the deductions are rarely used or not used at all, though they could still serve their purpose for a small number of taxpayers.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state the purpose of these tax expenditures. We inferred that the purpose of the Disposition of Assets Deductions is to prevent increased state taxable income, due to Colorado's 1965 transition to using federal taxable income as the starting point for Colorado taxable income, for taxpayers who sell or otherwise dispose of assets with a higher Colorado adjusted basis than federal adjusted basis.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to these tax expenditures.

DEDUCTIONS FOR ASSETS HAVING A HIGHER COLORADO ADJUSTED BASIS THAN FEDERAL ADJUSTED BASIS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two parallel income tax deductions: (1) Deduction for Individuals, Estates, and Trusts for Income from the Disposition of Assets Having a Higher Adjusted Basis for Colorado Tax Purposes than Federal Tax Purposes [Section 39-22-104(4)(b), C.R.S.]; and (2) Deduction for Corporations for Income from the Disposition of Assets Having a Higher Adjusted Basis for Colorado Tax Purposes than Federal Tax Purposes [Section 39-22-304(3)(c), CR.S.] (Disposition of Assets Deductions). These deductions allow taxpayers to reduce their Colorado gross income to account for differences between the state and federal calculation of an asset's basis when the asset is sold or disposed of.

“Basis” is generally the amount of a taxpayer's, either an individual or any type of business, investment in personal and business property, including assets such as land, buildings (including personal residences), stock, equipment, and intangible assets such as patents. For tax purposes, basis generally has two roles: (1) determining annual depreciation amounts for business assets and (2) determining the taxpayer's loss or gain when they sell or otherwise dispose of an asset. For example, if an asset is defined as 10-year property under the Internal Revenue Code and must be depreciated equally each year, a taxpayer with an asset that has a \$100,000 basis would deduct \$10,000 every year and lower the basis of the asset by \$10,000 every year until the basis reaches \$0. Once a taxpayer's basis reaches \$0, when they sell an asset, all of the proceeds are considered a gain. Taxpayers depreciating assets must generally file a federal Form 4562 with their federal income tax returns.

When a taxpayer purchases an asset, their basis in the asset is generally their cost to acquire the asset. Other events, such as exchanges and transfers of assets, may also provide a taxpayer with their basis in an asset. For example, taxpayers who inherit an asset may be able to claim the fair market value of the asset at the time of inheritance as their basis. Certain transactions or events may result in the basis of the asset being increased or decreased after the taxpayer acquires it. For example, in certain instances, capital improvements, zoning costs, and some legal fees may increase an asset's basis, and depreciation, casualty or theft losses, and easements may decrease an asset's basis. When adjustments are made to an asset's basis, it is referred to as the adjusted basis.

When a taxpayer sells or otherwise disposes of an asset, they must calculate their gain or loss on the transaction, as follows:

$$\text{Amount Realized (e.g., Sales Price)} - \text{Adjusted Basis in the Asset} = \text{Gain/Loss}$$

Prior to 1965, Colorado generally required taxpayers to calculate their state taxable income independently from federal tax law and provided its own requirements for taxpayers to calculate an asset's adjusted basis for Colorado tax purposes. In 1964, the General Assembly enacted the Colorado Income Tax Act of 1964 [House Bill 64-1003], which provided that Colorado taxable income would be based on federal tax laws in tax years beginning after December 31, 1964, and it no longer required the adjusted basis of assets for Colorado tax purposes be calculated separately. Therefore, for assets acquired in tax years beginning on or after January 1, 1965, the federal adjusted basis and Colorado adjusted basis of assets will generally be the same.

However, for assets acquired prior to 1965, House Bill 64-1003 created a potential discrepancy since these assets could have had a higher basis for Colorado tax purposes than for federal tax purposes based on the way Colorado had previously calculated an asset's basis. In particular, assets held for business purposes, which are typically depreciated, could have been subject to this difference. This is because when businesses depreciate assets (i.e., spread the cost of an asset over multiple years for tax and accounting purposes), for state and federal tax purposes, they are

able to deduct the amount of depreciation from their gross income, but they must also decrease the assets' basis by a corresponding amount. However, Colorado's laws prior to 1965 may have provided a depreciation deduction that was different from the federal depreciation deduction, although we were not able to confirm this. In that case, an asset's adjusted basis for Colorado tax purposes would have been different from the asset's federal adjusted basis. To the extent that Colorado allowed less depreciation to be deducted, the asset would have had a higher basis for Colorado tax purposes, and the business would have had a smaller gain or larger loss, and thus, a lower tax liability. Conversely, if Colorado allowed more depreciation to be deducted, the asset would have had a lower basis for Colorado tax purposes, and the business would have had a larger gain or smaller loss, and thus, a higher tax liability. With the implementation of House Bill 64-1003, taxpayers no longer calculated an asset's basis separately for Colorado, but instead generally applied the same basis as for federal tax purposes. In those instances where an asset would have had a higher adjusted basis for Colorado tax purposes than under the federal calculation, under the new law, the taxpayer would have had a larger taxable gain or smaller loss, and thus, a higher tax liability.

The Disposition of Assets Deductions, which were included in House Bill 64-1003, address this issue by allowing taxpayers to subtract from their federal taxable income when calculating Colorado taxable income the "portion of any gain or loss from the sale or other disposition of property having a higher adjusted basis for Colorado income tax purposes than for federal income tax purposes." Because taxpayers generally use the federal basis calculation for both Colorado and federal tax purposes for assets purchased in Tax Year 1965 and later, the deductions only apply to assets purchased before January 1, 1965. Neither House Bill 64-1003 nor current statute [Sections 39-22-104 and 39-22-304, C.R.S.] provide a state add back provision if an asset has a lower adjusted basis for Colorado tax purposes than federal tax purposes. EXHIBIT 1.1 shows how taxpayers calculate the deduction based on a hypothetical scenario that likely applied at the time the deductions were established.

EXHIBIT 1.1.
CALCULATION OF FEDERAL AND COLORADO GAIN ON
DISPOSITION OF AN ASSET WITH A HIGHER ADJUSTED BASIS
FOR COLORADO TAX PURPOSES THAN FEDERAL TAX
PURPOSES

FEDERAL GAIN AND TAXABLE INCOME CALCULATION		
Amount Realized		\$ 100,000
Federal Adjusted Basis of Asset	-	\$ 50,000
Federal Gain	=	\$ 50,000
Federal Taxable Income ¹		\$ 50,000
COLORADO GAIN CALCULATION		
Amount Realized		\$ 100,000
Colorado Adjusted Basis of Asset	-	\$ 60,000
Colorado Gain	=	\$ 40,000
Deduction for Assets Having a Higher Colorado Adjusted Basis Amount (Federal gain - Colorado gain)		\$ 10,000
COLORADO TAXABLE INCOME CALCULATION		
Federal Taxable Income		\$ 50,000
Deduction for Assets Having a Higher Colorado Adjusted Basis	-	\$ 10,000
Colorado Taxable Income	=	\$ 40,000

SOURCE: Office of the State Auditor analysis of gain calculation.

¹ To isolate the effect of the Disposition of Assets Deductions, this example assumes there is no income besides the gain from the sale of the asset.

Individuals claim this deduction on Line 17 (Other Subtractions) of Form DR 0104AD, which is the Subtractions from Income Schedule that is attached to Form DR 0104 (Colorado Individual Income Tax Return). Estates and trusts claim this deduction on Line 5 (Other Subtractions) of Form DR 0105 (Fiduciary Income Tax Return). C-Corporations claim this deduction on Line 13 (Other Subtractions) of Form DR 0112 (Colorado C Corporation Income Tax Return).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of these tax expenditures. Based on the statutory language of the deductions, interactions between the federal and Colorado tax law, Department of Revenue taxpayer guidance documents, and discussions with certified public accountants (CPAs) in Colorado, we inferred that the intended beneficiaries of the deductions are Colorado individuals, estates, trusts, and corporations that acquired assets prior to 1965 that had a higher

Colorado adjusted basis than federal adjusted basis and that dispose of those assets in or after 1965.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state the purpose of these tax expenditures. Based on the language in statute [Sections 39-22-104(4)(b) and 39-22-304(3)(c), C.R.S.], legislative history, and interactions between federal and Colorado tax law, we inferred that the purpose of the Disposition of Assets Deductions is to prevent taxpayers from having increased state taxable income due to Colorado's transition to using federal taxable income as the starting point for Colorado taxable income, when they sell or otherwise dispose of assets with a higher Colorado adjusted basis than federal adjusted basis. Specifically, because these deductions were created with the same legislation (House Bill 64-1003) that transitioned Colorado from calculating its own income tax base to using the federal income tax base as the starting point for determining Colorado taxable income, we inferred that these deductions are structural tax expenditures that were intended to reconcile the federal and state tax systems due to this transition.

ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Disposition of Assets Deductions are meeting their purpose, but they appear to be rarely used.

Statute does not provide quantifiable performance measures for these deductions. Therefore, we created and applied the following performance measure to determine the extent to which the tax expenditures are meeting their purpose:

PERFORMANCE MEASURE: *To what extent are individuals, estates, trusts, and corporations using the Disposition of Assets Deductions to prevent increased Colorado taxable income when they sell or dispose of assets with a higher Colorado adjusted basis than federal adjusted basis?*

RESULT: Due to their age and qualification requirements, it appears that

the deductions are rarely used or not used at all. Although we were unable to determine whether anyone has claimed these deductions in recent years, we consulted with 30 CPAs practicing in Colorado, and only one CPA mentioned they had seen the deduction claimed once by an individual for a transaction related to real property.

Additionally, there appear to be few instances in which these deductions would continue to be applicable. Specifically, because 54 years have passed since 1965, it is likely that assets taxpayers acquired and depreciated before this time have already been disposed of or sold. Further, even assets that were acquired prior to 1965 and are still owned by businesses in 2019 would likely have been fully depreciated for state and federal tax purposes, meaning that the adjusted basis for both federal and state purposes would be \$0. In either case, the deductions would no longer apply because the assets would no longer have a higher adjusted basis for state tax purposes than for federal tax purposes.

Therefore, regarding current and future use, these deductions are potentially most applicable for the disposition of non-depreciable assets that are held for long periods, e.g., land. For this reason they could still serve their purpose for a small number of taxpayers. However, in order for the deductions to be necessary for a taxpayer, the state adjusted basis of these types of assets must be higher than the federal adjusted basis, and we were unable to identify any applicable tax provisions that would have given rise to a difference in state and federal adjusted basis of non-depreciable assets prior to 1965.

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

Because there appear to be few circumstances under which the Disposition of Assets Deductions apply, we determined that they likely have little or no revenue impact to the State. Although we lacked data to confirm whether anyone has claimed the deductions in recent years, after consulting with several CPAs and the Department of Revenue, we determined that these deductions would rarely be used by taxpayers. Additionally, if there is a revenue impact, it would likely happen in

isolated years in which a taxpayer disposed of an asset that they had held for a long period. Furthermore, the deductions only apply to the gain or loss resulting from the difference in Colorado and federal adjusted basis. Therefore, if there were a revenue impact, it would likely be minimal, since this impact of this difference would be limited.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Disposition of Assets Deductions were eliminated, it would have minimal impact on beneficiaries. One CPA mentioned that it is a rarely used deduction, but if a rare instance occurred in which a taxpayer needed to use it, eliminating the deduction would result in the taxpayer having a higher Colorado taxable income and consequently a higher Colorado tax liability, as demonstrated in EXHIBIT 1.2.

EXHIBIT 1.2. CALCULATION OF COLORADO TAXABLE INCOME AND TAX LIABILITY WITH AND WITHOUT THE DEDUCTIONS		
CALCULATION OF GAIN		
	FEDERAL	COLORADO
Amount Realized (e.g., Sales Price)	\$ 55,000	\$ 55,000
Adjusted Basis of Asset	\$ 50,000	\$ 52,000
Gain	\$ 5,000	\$ 3,000
State Deduction Allowed (Federal Gain - Colorado Gain)		\$ 2,000
TAX CALCULATION		
	COLORADO TAX CALCULATION WITH DEDUCTION	COLORADO TAX CALCULATION WITHOUT DEDUCTION
Federal Taxable Income ¹	\$ 5,000	\$ 5,000
Deduction	-\$ 2,000	
Colorado Taxable Income ²	= \$ 3,000	\$ 5,000
Colorado Tax Liability (Colorado taxable income x 4.63 percent)	\$ 139	\$ 232

SOURCE: Office of the State Auditor analysis of state tax laws.

¹ For simplification purposes, this example assumes there was no other income or gains during the year.

² For simplification purposes, this example assumes no other adjustments are necessary.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

We identified at least 10 other states with a similar deduction for individuals, estates, and trusts and 18 other states with a similar deduction for corporations. Deductions arising from the need to reconcile state and federal adjusted basis for income tax purposes are more common in states that have decoupled from federal laws that allow bonus depreciation, which generally allows businesses to reduce their tax liability by taking larger depreciation deductions earlier in an asset's useful life. When the federal government allows bonus depreciation to be taken on property and a state disallows bonus depreciation, the property's adjusted basis will be higher for state income tax purposes than federal income tax purposes.

We did not identify any other Colorado tax expenditures, federal tax provisions, or programs with a similar purpose.

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

The Department of Revenue was not able to provide us with data for the individuals, estates, trusts, or corporations that claimed the deductions. Individuals claim the deduction on Line 17 (Other Subtractions from Federal Taxable Income) of Form DR 0104AD . Estates and trusts claim the deduction on Line 5 (Other Subtractions) of Form DR 0105. Corporations claim the deduction on Line 13 (Other Subtractions) of Form DR 0112. The Other Subtractions lines of these forms include several other deductions, which cannot be disaggregated. In all cases, taxpayers are required to submit explanations for the deductions taken as Other Subtractions, but GenTax, the Department of Revenue's tax processing system, does not capture the explanations.

In order to accurately determine how many taxpayers took the deductions and their revenue impact, the Department of Revenue would have to create new reporting lines on its Forms DR 104AD, DR 0105, and DR 0112 and then capture and house the data collected on those

lines, which would require additional resources (see the Tax Expenditures Overview section of the Office of the State Auditor's *September 2018 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Since it is likely that only very few, if any, taxpayers are claiming these deductions, it would not be practical to amend these forms.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to these tax expenditures.