Report of the
Task Force Concerning Tax Policy

2023 Report

Submitted to the

Legislative Oversight Committee Concerning Tax Policy

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Task Force Concerning Tax Policy

Membership as of December 1, 2023

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Introduction

The Task Force Concerning Tax Policy (Task Force) submits this report on options for expanding the sales and use tax to apply to services and issues concerning using Federal Adjusted Gross Income or Federal Taxable Income as the basis of the state's income tax pursuant to Title 22 of Article 39 of the Colorado Revised Statutes. The purpose of this Task Force is to study tax policy within the scope as defined by the Legislative Oversight Committee Concerning Tax Policy and to develop and propose tax policy modifications for consideration. The Task Force was charged by the oversight committee to provide information on:

- options for expanding the sales and use tax to apply to services, including but not limited to tangible personal property services, real property services, and/or personal and professional services, with attention to the long-term impacts on the tax base, the effects on households of different incomes, business-to-business transactions, vertically integrated businesses, and tax pyramiding; and
- issues concerning using Federal Adjusted Gross Income or Federal Taxable Income as the basis of the state's income tax.

Over the course of two legislative interims, the Task Force engaged in robust discussions on the information discussed below. The Task Force encourages readers to assess the entirety of the document to capture the significant complexity underlying the issues reviewed. All presentations, meeting summaries, and handouts from the Task Force's meetings are posted on the Task Force website here:

https://leg.colorado.gov/content/ilocctptf2023asubpanelsched

In a larger context, the Task Force also advises that any future initiative to make a major change to tax policy should be done with a perspective on the total tax burden, the costs versus benefits of switching, and with a specific revenue or policy goal in mind. These issues are captured throughout the sections below, but were very much part of the verbal deliberations of the Task Force.

The Task Force believes that the three most important issues when evaluating a major tax policy change are the effects of the policy change on

- revenue generation;
- distribution of tax burden; and
- improvements to administrative efficiency.

The Task Force believes other well-known principles of taxation are to be followed as well.

To the extent the discussion in this document implies only revenue-neutral changes to tax policy, the Task Force notes that some future initiatives could generate revenue in a manner or in amount that would require voter approval or constitutional changes in addition to legislation.

Sales and Use Tax

The Task Force in its recent hearings took up the issue of extending the sales tax to services not already taxed. At the highest level, the idea about widening the sales tax base and lowering the overall rate had for several members some theoretical attraction. Over the course of the presentations, the reality of the potential implementation showed there are significant implementation complexities. Around the United States, the taxation of services is mixed and some efforts were ultimately abandoned.

Included in the sections that follow is some background information on the current Colorado sales tax system and history, potential impacts of taxing services to state and local governments, and key considerations for the executive and legislative branches to consider prior to any changes. The Task Force believes it has captured the most relevant issues for consideration.

Background on current system

State tax. Colorado is one of 45 states to assess a state sales tax.[1] Among states with a sales tax, Colorado's state sales tax is assessed at the lowest rate, 2.9 percent. The tax base includes all sales of tangible personal property except those that are specifically exempted, and excludes all sales of services except those that are specifically subject to the tax.[2] The state use tax is assessed when sales tax was due but was not collected. For instance, service providers in Colorado who purchase taxable tangible personal property for use in performing their services pay sales tax to the vendor of the property. If the vendor does not collect the tax or fails to collect the appropriate state and local tax rate, the service provider is required to remit use tax directly to the state and/or local jurisdiction. The state sales and use tax is administered by the Department of Revenue (DOR).

County taxes. With voter approval, counties are authorized to assess a sales tax, use tax, or both.[3] County sales taxes are imposed on the same collection of goods and services as the state sales tax, except that certain state sales tax exemptions are not by default extended to counties.[4] In these cases, boards of county commissioners may adopt an ordinance or resolution to extend the exemption(s). Notable state sales tax exemptions that are not necessarily available at the county level include the exemptions for: machinery; electricity, gas, and heating oil; food for home consumption; sales by charities; and retail marijuana. Sales taxes assessed by 52 counties are administered by DOR, which collects tax revenue and remits the tax to the appropriate county. The provisions governing county taxes do not apply to the consolidated city-county governments of Denver and Broomfield, each of which has a home rule charter. Twelve counties do not assess a sales tax.

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[1] Alaska, Delaware, Montana, New Hampshire, and Oregon do not assess statewide sales taxes.

[2] Section 39-26-104, C.R.S.

[3] Section 29-2-103, C.R.S.

[4] Section 29-2-105 (1)(d), C.R.S.

Municipal taxes. Provisions for municipal taxes vary greatly according to whether the municipality has adopted a home rule charter pursuant to Article XX of the Colorado Constitution. Municipalities that have not adopted a home rule charter are authorized by statute to assess sales or use taxes in a manner similar to the county taxes described above. Municipalities that have adopted a home rule charter have broad jurisdiction over their own sales taxes and generally are not bound by statutory sales tax requirements.

Statutory municipalities. With voter approval, municipalities that have not adopted a home rule charter (statutory municipalities) are authorized to assess a sales tax, use tax, or both.[5] Sales taxes assessed by these municipalities are imposed on the same collection of goods and services as the state sales tax, except that certain state sales tax exemptions are not by default extended to municipalities.[6] In these cases, the city or town council may adopt an ordinance or resolution to extend the exemption(s). Municipal sales taxes are administered by DOR, which collects tax revenue and remits the tax to the appropriate municipality.

Home rule municipalities. Article XX, Section 6, of the Colorado Constitution empowers any municipality with a population of 2,000 people or more to adopt a home rule charter with voter approval. Home rule municipalities have broad latitude to govern themselves in matters of local concern.[7] With voter approval, home rule municipalities may assess sales or use taxes on a locally determined collection of goods and services. Because municipal taxes need not be assessed on the same tax base as the state, home rule municipalities may variously tax transactions that are exempted at the state level or exempt transactions that are taxed at the state level. Additionally, home rule municipalities may tax specific goods or services at a different rate from others.

Home rule municipalities may choose whether to collect and administer their sales taxes locally. Municipalities that choose to collect their own sales taxes may develop their own systems for licensure, remittance, and auditing. Ninety-six home rule municipalities assess a sales tax. Sixty-eight home rule municipalities collect and administer their own sales taxes. DOR collects and administers sales taxes for home rule municipalities that choose not to administer their own sales taxes.

Special districts. With voter approval, certain special districts and other limited purpose governmental entities are permitted to assess sales taxes up to certain tax rate limits. Special districts authorized to assess sales taxes include:

- the Regional Transportation District in the Denver metropolitan area;
- the Scientific and Cultural Facilities District in the Denver metropolitan area;
- local improvement districts in Boulder, Broomfield, Douglas, Jefferson, and Mesa Counties;[8]
- mass transportation systems in Eagle, Pitkin, and Summit Counties;

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[5] Section 29-2-102, C.R.S.

[6] Section 29-2-105 (1)(d), C.R.S.

[7] City and County of Denver v. Qwest Corp., 18 P.3d 748 (Colo. 2001).

[8] Two separate improvement districts with different tax rates exist in both Jefferson and Mesa Counties.

- regional transportation authorities in Dolores, Eagle, El Paso, Garfield, Gunnison, Logan, Pitkin, and San Miguel Counties;
- a multi-jurisdictional housing authority in Summit County;
- a public safety improvement district in Delta, Mesa, and Montrose Counties;
- twelve metropolitan districts throughout the state;
- health services districts in parts of Douglas, Park, and Teller Counties, plus all of Delta and Montezuma Counties, and within the La Junta City limits ; and
- local marketing districts in Alamosa, Eagle, Gunnison, Larimer, Moffat, and Routt Counties.

Statutory requirements for each special district sales tax are included in the portion of state law that authorizes creation of the particular type of special district. In general, all special district sales taxes are collected and administered at the state level. The tax base for special districts is generally consistent with the state tax base, and changes to the state base (e.g., via the creation or repeal of a sales tax exemption) are extended by default to special districts.

With all these taxing jurisdictions and options, Colorado is known as one of the most complex and complicated states for sales and use tax collection and remittance purposes. A 2017 presentation by the DOR to the Sales and Use Tax Simplification Task Force identified a total of 294 different taxing jurisdictions in Colorado with over 750 unique sales and use tax rate combinations. The city and county sales tax rates may change on January 1 or July 1 of each year. The number of taxing jurisdictions within Colorado and the number of rate combinations have grown since this presentation in 2017.

In all but five states across the U.S., all state and local sales taxes are administered by, reported and remitted to, and audited by the state taxing authority.[9] In these other states, the state and local sales tax rates typically apply to a tax base that is consistent for state and local sales tax collection and remittance purposes.

Policy Discussions and Impacts

Impact on State-Collected Entities. Unlike self-collected home rule municipalities that have more authority over their taxing definitions, entities that have sales tax collected by the state must follow the state's tax base, but have limited statutory authority in Section 29-2-105, C.R.S. and Section 39-26-127, C.R.S. to deviate from the state's base for certain sales tax exemptions. This is true of state-collected home rule municipalities, as well as statutory towns, statutory cities, certain special districts, and most counties. The DOR's publication, the "*DR-1002*" reports the rates and exemptions of state-collected local governments. Depending upon the economic makeup of a community, a change in definitions by either expanding or contracting the tax base, could result in significant impact to local governments. For instance, providing new exemptions could result in a significant revenue loss in some communities, while others may not be as impacted because of the nature of the tax base within the community. While some industry sectors are common in most local governments, the economic makeup of a mountain

[9] "Home rule" or similar local taxing jurisdictions are currently allowed in Alabama, Alaska, Arizona, Colorado, and Louisiana.

town can vary drastically from a plains community. Likewise, an expansion of the base may result in a significant increase in revenues that may run afoul of TABOR requirements. This could result in a process to return the excess revenue for the government entity. Individual jurisdictions that recognize a more than *de minimis* increase in revenue may find ways to either offset the increase or may choose to seek voter approval to retain the excess. The Task Force noted the expenses or complications with revenue retention elections, however.

In order to pass measures at the state-level that are "revenue neutral" for compliance with TABOR and subsequent case law without a statewide vote on the issue, the state could consider lowering its sales tax rate to offset the expanded base. But, even assuming that such a measure without voter-approval did not violate TABOR, it may still raise issues with state-collected local governments. For example, while a revenue-neutral change may be a feasible option for the state, the rates at the local level would not be affected by the state's change. Therefore, the state measure could have a collateral result on local governments: a tax policy change directly causing a net tax revenue gain that was not approved via a vote of the local electorate. It is unclear if this policy change at the state level, which could feasibly be revenue neutral or have a *de minimis* impact, would be in harmony with TABOR requirements. Since a broadening of the sales tax base to this magnitude is a matter of first impression, it is difficult to determine if there would be legal implications and liability to local governments as a result.

Another potential impact to local governments is attributable to the intra-state economic competitive advantages between communities' sales tax bases. It is feasible that an expansion of the sales tax base to services, which by default would only apply to state-collected local governments, could cause additional challenges for recruitment and retention of service industry businesses within a local government that is obligated to charge the tax when a neighboring jurisdiction may not. Consumers will also favor spending dollars in communities where tax rates are lower, albeit to a small degree.

Impact on Home Rule Municipalities. Article XX, Section 6 of the Colorado Constitution grants home rule municipalities the authority to impose, legislate, and administer municipal taxation. Therefore, amendments to Article 26 of Title 39, C.R.S. (Sales and Use Tax Code) seeking to broaden the sales and use tax base will not impact the sales and use tax base for self-collected home rule municipalities that impose/administer their own sales and use tax codes. Of the 106 home rule municipalities, 68 have exercised[10] their constitutional authority to self-collect.

It should be noted that in 2017 the Colorado General Assembly created the Sales and Use Tax Simplification Task Force (SUTS Task Force).[11] The SUTS Task Force studies sales and use tax simplification between the state and local governments, in particular between the state and home rule jurisdictions. Any efforts by the Legislative Oversight Committee Concerning Tax Policy to amend Article 26 of Title 39, C.R.S. should be coordinated with the SUTS Task Force to

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[10] Colorado Municipal League: https://www.google.com/url?q=https://www.cml.org/home/advocacy-legal/Members39-Guide-to-Legal-Consulting-Services-and-Amicus-Briefs/Sales-Tax-Standard-Definitions-Project&sa=D&source=docs&ust=1699825600559036&usg=AOvVaw2xqkprtAMhsKUSRGzh2QjF.

[11] Sales and Use Task Force: https://www.google.com/url?q=https://www.cml.org/home/advocacy-legal/Members39-Guide-to-Legal-Consulting-Services-and-Amicus-Briefs/Sales-Tax-Standard-Definitions-Project&sa=D&source=docs&ust=1699825600559036&usg=AOvVaw2xqkprtAMhsKUSRGzh2QjF

ensure that proposed amendments do not negatively impact the efforts to simplify sales and use taxation in Colorado. In addition, the DOR issued a report in 2013 that examined the differences between the sales tax base and exemptions of the state versus locals, and provided recommendations on how to simplify and create more uniformity.[12]

Other Points of Discussion

- When the sales tax was first created in 1935 it was levied on the general retail sales of tangible personal property. At that time, approximately 57 percent of personal consumption expenditures (PCE) was for the purchase of goods, with approximately 43 percent of PCE for the purchase of services. Prior to the COVID pandemic approximately 30 percent of PCE was spent on goods and nearly 70 percent of PCE was spent on services. The pandemic's impact was to change the numbers slightly, but the overall trend appears to be the same, an increasing percentage of personal consumption is being spent on services.
- Notably, from 1937 to 1945, Colorado's sales tax base actually included most services.
- If the state chose to add additional services without taking offsetting revenue reduction action, the outcome would be an increase in revenue. Increased revenues from changes in the sales tax base may raise questions under TABOR whether the change is a "tax policy change" requiring voter approval. The Task Force is not making a judgment on the legality or practicality of specific proposals, only trying to highlight the issue around TABOR and at what point a vote would be required.
- One of the questions around the taxing of services is would it create a more equitable tax system. The thought would be that if the amount of revenue was greatly increased, then the tax rate could be decreased. Sales tax by its nature is regressive, i.e. it takes a larger percentage of income from low income earners than middle or high income earners. By adjusting the rate downwards to keep the change revenue neutral, low income workers would pay a smaller portion of their income in sales tax. This of course presumes that the low income workers would not be using the services that would be added to taxable items, which is an issue that must be addressed with any decision to add services to the sales tax list. The Task Force is not in a position of offering an opinion on this matter because there is no clear answer.
- Equity can also be examined through the taxability of similar purchases by different consumers (e.g. horizontal equity). For example, it can be argued that a system where buyers of gym equipment (tangible personal property) pay sales tax but buyers of a gym membership (service) don't is inequitable.
- Based on a 2017 Federation of Tax Administrators survey, Colorado taxes the seventh-lowest number of services in the US (and for reference, across all taxes, CO has the sixth-lowest state tax burden in the US). However, the study did not differentiate or identify states that

[12] Department of Revenue Report: https://www.google.com/url?q=https://tax.colorado.gov/sites/tax/files/Uniform_Sales_and_Use_Tax_Base_Report_12-2013.pdf&sa=D&source=docs&ust=1699825600567980&usg=AOvVaw1-jvz3xKQggzUIQAoefdcj

more heavily rely on sales or gross receipts taxes because those states do not impose an income tax. This reflects the Task Force's advice to consider the entire tax burden in the state when considering an initiative to extend sales tax to more services.

- Extending sales tax to services may result in multiple levels of taxation. The Task Force discussed vigorously the issues of tax burden and administrative complexity of this issue. This point is important for policymakers to assess completely. For instance, consider the gym membership mentioned above. The owner of the gym pays sales or use tax on all of the gym equipment and other tangible personal property as well as some of the services consumed at the gym. If the gym membership is also taxed, both the service provider and the ultimate consumer would be paying tax on the use of these items. The Task Force was not unanimous regarding if this example creates a problematic policy situation.
- Extending sales tax to services may result in the taxation of business-to-business transactions. However, this already occurs to an extent with our taxation of tangible personal property, and to the extent policymakers want to mitigate such impacts, these can be reduced by coupling expansion with the expansion of the sale-for-resale exemption. According to the Bureau of Economic Analysis, the services with the highest share of purchases by businesses (rather than individuals) are computer systems design and related services (100 percent business), management of companies and enterprises (100 percent business), administrative and support services (93 percent business), and waste management and remediation services (78 percent business). The General Assembly may need to consider the appropriateness of additional types of resale certificates, exemptions, or definitional exclusions for services, similar to upstream considerations in our tax policy system for the production of items of tangible personal property.

Areas for Further Consideration

The state of Colorado could pursue two generalized approaches to expanding the sales tax base to include more services. The first approach would involve categorizing all services as taxable, and selectively exempting certain ones. The second approach would involve altering the existing tax code to add specific services to the tax base. Though there is no consensus recommendation from the Task Force on the correct approach, the following seven bullets reflect areas for consideration when deciding whether or not to implement a tax on a service if using the second approach.

- ***Tax pyramiding.*** A consideration with the broad expansion of the sales tax is whether the taxation of goods and services should occur at multiple stages on the way to the production of the final product. For tangible personal property, business-to-business transactions that occur prior to the retail sale are addressed in a variety of ways under current laws. For example, raw materials incorporated into a final product through a manufacturing process are not subject to sales and use tax. But, broadening sales tax to services would require policymakers to make similar considerations for these new types of retail sales on services activities. The General Assembly may need to consider the appropriateness of additional types of resale certificates, exemptions, or definitional exclusions for services, similar to upstream considerations in our tax policy system for the production of items of tangible personal property.

- ***Regressivity.*** In the evaluation of expansion of the sales tax base, it would be important to consider how an increasing share of taxes collected from consumption impacts individuals and households based on level of income. There are policy mechanisms that can offset potential regressivity of various degrees of complexity or administrative burden that could be considered as part of policy reform.
- ***Compliance.*** Colorado has recently gone through significant efforts to simplify the collection, reporting and remittance of sales taxes by companies across the state. Expanding the sales tax base to include a new service should also consider the challenge for companies to comply with the new law, with both their ability to calculate their obligation and to have uniformity across the state. *Sales and Use Tax Simplification Task Force | Colorado General Assembly*
- ***State competitiveness.*** Given the inconsistent application of taxation on services across states, expanding Colorado's taxation of services could have unintended impacts on the competitiveness of certain companies. It should be understood the degree to which a potential taxable service could be more easily imported from other states/countries, and whether that service is regularly taxed in other regions. The Federation of Tax Administrators conducted a survey several years ago to give some insight into which services are taxed across states. *Sales Taxation of Services (taxadmin.org)*
- ***Interactions with TABOR.*** The constitutional amendment known as TABOR stipulates several constraints to the changes of taxes in the state of Colorado. Members of the General Assembly are encouraged to consult directly with the Office of Legislative Legal Services to better understand whether a legislative change to expand taxation of services would require a vote of the people under TABOR. The provisions of TABOR related to tax changes are explored in more detail in an earlier section of the paper.
- ***Disproportionate impacts on different areas of the state.*** Depending on the specific tax under consideration, there may be disproportionate impacts on jurisdictions across the state. This could be especially true if the expansion of sales taxes were considered in a revenue neutral framework. For example, if the sales tax base were expanded, but the state tax rate were lowered, certain jurisdictions would not experience a revenue neutral change, even if it were estimated at the state level. There is some direct experience with this when sourcing rules were changed, and jurisdictions which were already streamlined saw reductions in revenue. There could be consideration of a state revenue back-fill or another mechanism to offset net losses for local jurisdictions.
- ***Evaluate taxable service categories at a more specific service level vs. service category.*** The devil is in the details. The more specific the proposed taxable service can be defined as, the easier it will be to evaluate the potential impacts and run through the six areas of consideration outlined above. Greater specificity will also increase clarity on compliance. However, the flip side to greater specificity will also potentially be greater tax avoidance. It will be important to balance these two competing challenges when defining each potential tax change.

The Task Force has not had time to review specific categories or specific services to evaluate as candidates for addition to the sales tax base. To the extent the Committee wishes the Task Force to continue this inquiry, it would evaluate specific categories of services around the above listed factors.

Federal Adjusted Gross Income or Federal Taxable Income for Income Tax Policy

In its first series of meetings in 2021, the Task Force heard presentations and had discussions on the issue of using Federal Adjusted Gross Income (AGI) rather than Federal Taxable Income (FTI) as is currently the case for the basis of the state's income tax. A change to how Colorado approaches this question very much relates to the policy and revenue goals driving the discussion. More pressingly, the Tax Cuts and Jobs Act will expire in 2025 and Colorado will have to evaluate the impact of Congress' extension or not of that legislation. As shown below, issues of compliance simplicity, predictability of revenue, and equity/progressivity all feature significantly in the analysis.

As with the sales tax on services discussion above, the Task Force recommends that the Executive and Legislative branches approach the issue with a clear policy and revenue goal as well as detailed modeling to understand the impact on individuals and businesses. We note that this should also include a strong analysis on any higher administrative costs to implement the new approach.

The Task Force identified three questions to further define the objective of evaluating using the base of AGI or FTI.

1. ***Is the Legislature's objective to increase revenue, to lower revenue, or to remain neutral?***
2. ***Is the Legislature's objective to start with a broader base and whittle it down (via additional deductions) or to start with a narrower base and exercise control through additions to the base?***
3. ***Is the Legislature's objective to insulate stakeholders from the impact of federal changes, i.e. increase our autonomy? For example, at the present time, when the federal government changes its FTI base, Colorado's income tax base also changes.***

The choice of where to begin our state individual income tax base - at AGI or FTI - depends on the above goals and involves many tradeoffs. In addition, fine points of various proposals are essential to understand as well as the attributes of Colorado's current policy. For example, Colorado is not squarely in either an FTI or AGI designation (though thought of as an FTI state). One example is the adoption of *Proposition FF* in 2022 which effectively taxes individuals based on AGI if they earn above a certain threshold. Another example is when the Colorado "de-coupled" from federal definitions to expand the Child Tax Credit in *House Bill 23-1112*. Broadly speaking, Colorado could move from FTI to AGI but then "copy and paste" the federal standard deduction, Section 199A qualified business income deduction for pass-through businesses, and itemized deductions into state statute exactly as they are in federal statutes. Such a move would make us an AGI state and technically further "decouple" us from the federal income tax code, but would have no substantive effect on state revenues or taxpayer experience (besides potentially adding length to our state return). On the other hand, we could move from FTI to AGI but not implement any of the above federal deductions in our state code, in which case the move would have a massive (positive) revenue impact for the state and result in

significant tax increases for state taxpayers. Most discussions of "FTI vs. AGI" involve options in between these two extremes.

The Task Force recommends the following issues be evaluated for all cases of changing the basis of the state's income tax. The primary considerations are:

- Rolling vs. fixed-date conformity. For example, should Federal changes occur automatically or should Colorado actively determine the definition of taxable income on a scheduled basis.
- Tax equity and fairness issues. If AGI & FTI are in the same proportion for each taxpayer, there is no equity issue. If it is not in proportion for everyone, there would be an equity issue.
- TABOR considerations - In some cases, a change in tax base may require voter approval.
- Administrative impacts on the Colorado DOR of changing or moving away from IRS. Some changes from the status quo will have large administrative costs that need consideration.
- Taxpayer simplicity and compliance. The current system is relatively easy to comply with and understand.

Relevant Background on the Issue

Like most states, Colorado generally conforms its calculation of taxable income to the federal calculation prescribed by the Internal Revenue Code. This section will discuss how Colorado and other states achieve such conformity, and the benefits and drawbacks of conformity generally. Then it will turn to a comparison of the similarities and differences between starting with adjusted gross income or federal taxable income. As this section illustrates, the choice of a starting point will not necessarily affect tax revenues or base control, but could affect complexity and uniformity with other states.

Adjusted gross income is a concept that is generally applicable to individuals.[13] Though the general concepts of federal conformity, including the benefits and drawbacks, will be applicable to the income taxes on corporations, estates, and trusts, the comparison of adjusted gross income and federal taxable income will not. For corporate income tax purposes, most states begin with federal taxable income either before or after net operating losses and special deductions.[14] Likewise, most states base the income taxation of estates and trusts on federal taxable income.

Federal Conformity Generally

Because the federal government and most state governments impose a tax on individual income, states have sensibly concluded that they should align their taxes with the federal scheme, at least to some degree. This section will discuss the ways that states achieve

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[13] See I.R.C. § 62(a).

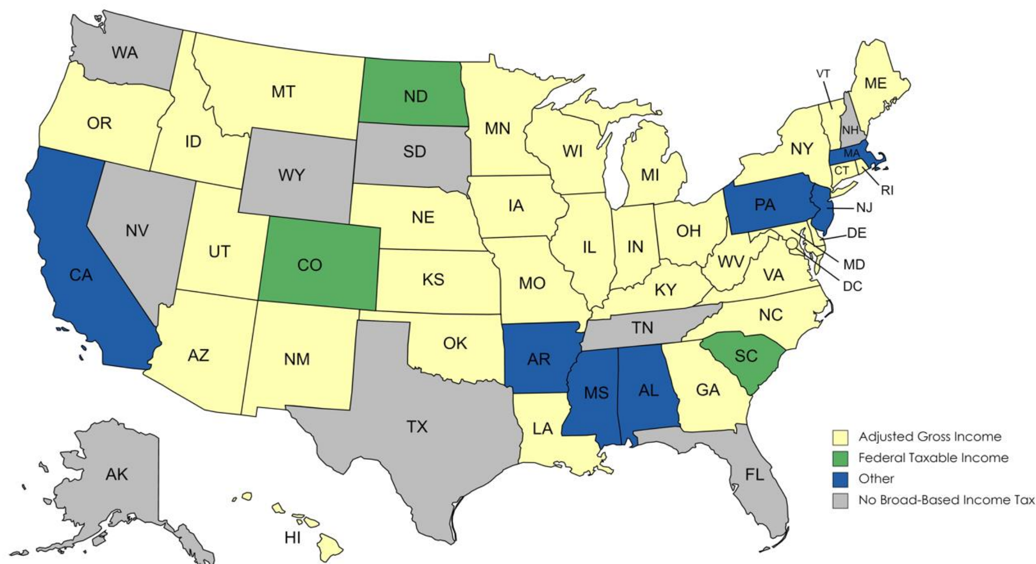
[14] Colorado begins with federal taxable income after net operating losses and special deductions. However, corporations must immediately add back their federal net operating loss deduction pursuant to Section 39-22-303(2)(c), C.R.S. In lieu of the federal net operating loss deduction, corporations are allowed an allocated and apportioned net operating loss deduction under Section 39-22-504 C.R.S.

conformity with the Internal Revenue Code, why conformity is beneficial for state tax administrators and taxpayers, and some drawbacks to federal conformity.

In general, states achieve conformity by starting their calculations of state taxable income with a figure derived from the Internal Revenue Code. For example, Colorado's income tax on individuals is imposed upon the individuals "federal taxable income, as determined pursuant to section 63 of the Internal Revenue Code."[15] By conforming its starting point to this figure, Colorado is accepting all of the income included and excluded, and all of the deductions allowed or not allowed, in computing it under the federal code. These elements are discussed further below.

As the map below illustrates, most states (31 plus the District of Columbia) start with adjusted gross income. Colorado, North Dakota, and South Carolina start with federal taxable income. Seven states start with some other base, mostly related to federal gross income.[16] In any case, almost all states with a broad-based income tax[17] are conforming, to some degree, by pinning their starting point to a figure derived from the Internal Revenue Code.

Figure 1: Current State Starting Points



Source: Thomson Reuters Checkpoint database and Task Force Concerning Tax Policy members.

In addition to establishing a starting point, states also vary in the version of the Internal Revenue Code used to define that starting point. Most states fall into one of two camps. Some states, including Colorado, use what is called rolling conformity. As noted above, Colorado's starting

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[15]Section 39-22-104(1.7)(b), C.R.S.

[16] Massachusetts, for example, uses federal gross income, and until recently, had a federal conformity date of 2005.

[17] Nine states do not currently impose a broad-based, individual income tax. They are Alaska, Florida, Nevada, New Hampshire (interest and dividends tax), South Dakota, Tennessee, Washington, and Wyoming.

point is federal taxable income as determined pursuant to the "Internal Revenue Code." "Internal Revenue Code" is, in turn, defined as "the Internal Revenue Code of 1986, as amended."[18] In other words, when Congress amends the Internal Revenue Code in a way that changes the calculation of federal taxable income, Colorado automatically incorporates that amendment into its calculation. The state legislature must then enact legislation to reverse the effects of any undesirable changes. The inverse is also true. Colorado benefits from desirable amendments without the need for legislative action. Other states are more selective using an approach called static conformity. Their definition of "Internal Revenue Code" might replace "as amended" with "enacted on or before" a particular date. Those states would then incorporate later changes by moving that date forward while simultaneously accounting for any undesirable federal changes that occurred in the meantime.

As these two approaches to timing illustrate, there are benefits and drawbacks to conformity. Overall, the various approaches to conformity are attempts to balance administrative efficiency with policy and budget control.

One of the fundamental benefits of federal conformity is efficiency. Important figures need to be calculated only once, which also streamlines accounting processes (though the impact is reduced for taxpayers who use electronic software to file). Burdens on multistate taxpayers are reduced by uniformity. States and taxpayers can leverage federal rules, guidance, administrative rulings, and court decisions to determine the proper amount of tax due. Finally, states can leverage federal data matching and federal audits to monitor compliance. The utility of federal data matching is not limited to the starting point. Additions to and subtractions from federal taxable income (or adjusted gross income) may rely on federal return figures.[19] In this respect, even carefully designed deviations from the federal taxing scheme may not completely sacrifice the efficiency of federal and state conformity.

The trade-off to federal conformity is the attendant cession of policy and budget control to Congress, at least temporarily. States may have different budget or policy priorities or constraints than the federal government. In particular, most states have constitutional or statutory balanced budget requirements. In rolling conformity states, some desirable or undesirable federal policies are automatically adopted unless the state legislature promptly enacts legislation to reverse them at the state level. In static conformity states, the legislature must advance the conformity date without reversing the effects of interim federal changes. In either case, decoupling may be financially or politically challenging.[20]

Adjusted Gross Income vs. Federal Taxable Income. In order to understand the effects of choosing adjusted gross income or federal taxable income as the state's starting point, it is

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[18] Section 39-22-103(5.3), C.R.S.

[19] State credits—which are applied after state taxable income has been finalized and the tax rate has been applied—may also be based upon federal credits or deductions.

[20] Decoupling refers to the state legislature's decision to deviate from the federal treatment of an item of income, gain, loss, deduction, or credit. In a rolling conformity state, like Colorado, this typically occurs by legislation requiring the addback of a federal deduction, or the subtraction of a benefit not allowed under the Internal Revenue Code. In a static conformity state, decoupling could occur because of the legislature's inaction on advancing the conformity date, or by enacting addbacks or subtractions along with the advancement of the conformity date.

important to understand the difference between the two. This section will detail those differences then highlight why they will not necessarily impact state revenues.

As the 2022 IRS form 1040 highlights, there are several important figures used in calculating an individual's federal income tax liability. Line 9 is a taxpayer's total or gross income. As section 61 of the Internal Revenue Code explains, and lines 1 through 8 illustrate, this figure broadly includes all income from whatever source derived. Line 10 summarizes a number of deductions from gross income that are used to arrive at adjusted gross income.[21] These include educator expenses and student loan interest.[22] The deductions applied to calculate adjusted gross income are often called "above-the-line" deductions. They do not require a taxpayer to itemize in order to benefit.

Three key deductions comprise the difference between adjusted gross income on line 11 and federal taxable income on line 15. First, the taxpayer may claim the standard deduction or the total of the taxpayer's itemized deductions.[23] Second, the taxpayer may claim a deduction for qualified business income. This deduction, added by the 2017 Tax Cuts and Jobs Act, is generally equal to 20 percent of the income from certain pass-through entities.[24] Finally, taxpayers may take a deduction for each personal exemption.[25] Taxpayers are entitled to a personal exemption for themselves, their spouses, and any dependents. The number of personal exemptions are multiplied by a fixed dollar amount to compute the deduction. The Tax Cuts and Jobs Act set the dollar amount to zero through tax year 2025.

By starting with federal taxable income, Colorado automatically incorporates things like the standard deduction and the zeroing of personal exemptions into its calculation. But no state is perfectly coupled with its starting point. For example, Colorado requires taxpayers at certain levels of adjusted gross income to add back the qualified business income deduction.[26] Conversely, Colorado permits the subtraction of a limited amount of contributions to a CollegeInvest savings account (also known as a 529 plan).[27] In fact, section 39-22-104, subsections (3) and (4), provide for 18 additions to federal taxable income and 20 subtractions from federal taxable income, respectively. Were Colorado to transition to adjusted gross income, some of the addbacks could be eliminated. For example, the addback for state income tax

[21] I.R.C. § 62 provides a full list of deductions allowed in calculating adjusted gross income.

[22] I.R.C. § 62(a)(2)(D) and (a)(17)

[23] In calculating taxable income, section 63 of the Internal Revenue Code permits an individual to claim any deduction allowed under Chapter 1 (except those above-the-line deductions used to compute adjusted gross income). This is often called "itemizing." Alternatively, section 63(b) permits taxpayers to claim a "standard deduction," which is a fixed amount intended to mimic the average itemized deduction amount. For tax year 2023, the standard deduction is $13,850 for single taxpayers and $27,700 for married taxpayers filing jointly. Taxpayers may claim whichever amount is most beneficial to them.

[24] I.R.C. § 199A.

[25] I.R.C. § 151.

[26] Section 39-22-104(3)(o), C.R.S.

[27] Section 39-22-104(4)(i), C.R.S.

deducted federally as an itemized deduction would not be necessary. Colorado simply would not allow itemizers to take the deduction from adjusted gross income in the first place.

In this respect, an important part of the choice to transition to adjusted gross income will be whether and how to retain the deductions from adjusted gross income allowed in computing federal taxable income. The change could be purely revenue-neutral if the statute was also adjusted to allow subtractions for the standard deduction, certain itemized deductions, the personal exemption, and the qualified business income deduction (for certain taxpayers).[28]

To remain perfectly coupled, the General Assembly would need to enact new legislation in the event that Congress changes any of these items at the federal level. If, on the other hand, the federal change did not align with Colorado's policies and priorities, the General Assembly would not need to legislate to maintain the status quo. Similar decoupling can be achieved with federal taxable income as a starting point, but it requires legislation to create an addback. Conversely, state legislation is unnecessary to remain in conformity with desirable federal changes. Finally, regardless of whether adjusted gross income or federal taxable income is the starting point, the General Assembly would need to act to reverse any undesirable changes to the calculation of adjusted gross income.

Recent State Adoptions of AGI

Both Minnesota and Vermont transitioned to AGI in the aftermath of the TCJA because they did not want to conform to many of its provisions, they did not want to have a huge tax swing after 2025 when it expires, and they had overall concerns about their revenue volatility because their tax bases are tied to federal taxable income.

Minnesota.[29] [30] Minnesota chose to set its standard deductions at the same level as the post-TCJA levels: $12,000 single and $24,000 joint. It also decided to keep its personal exemption at the pre-TCJA level ($4,250), but restricted it to dependents, meaning filers and spouses no longer received it. At the same time, to make for a more progressive shift in its tax code, it reduced a tax rate on one of its lower income tax brackets (though this option is not available to us in Colorado since all income has to be taxed at one rate). It also phased out its standard deduction, personal exemption, and itemized deduction for taxpayers making more than about $200,000 per year single, or about $300,000 per year joint. Finally, it chose not to have a pass-through deduction.

Notably, Minnesota's move to AGI may have been prompted by concerns about conforming to certain provisions of the federal tax code, but that has not stopped them from retroactively conforming to other parts. Earlier this year they enacted a law to bring their tax treatment of various federal relief programs in line with federal tax law.[31]

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[28] Related addbacks and subtractions would also need to be adjusted or repealed.

[29] Auxier, R., Rueben, K., Sayed, S., & Charleston, D. (2020, October 26). *What Colorado Can Learn from States that Recently Transitioned from FTI to AGI*. Tax Policy Center.

[30] HF 5, 2019 Reg. Sess. (Minn. 2019), https://www.revisor.mn.gov/bills/bill.php?b=House&f=HF0005&ssn=1&y=2019

[31] Karnowski, S. (2023, January 12). Tax relief bill gets Minnesota governor's 1st signature. https://apnews.com/article/abortion-politics-minnesota-state-government-timothy-walz-1dca206d5c2e28110f2b6f6139414bcd

Vermont.[32] [33] Vermont chose to set its standard deduction near the pre-TCJA amounts: $6,000 for single filers and $12,000 for joint filers. Similarly, it chose to set its personal exemption amount at the pre-TCJA level: $4,150, available to filers, spouses, and dependents. Like Minnesota, Vermont also wanted to use this tax reform opportunity to push for a more progressive tax code, so it slightly reduced tax rates for its lowest income brackets and increased its state EITC credit from a 32 percent match of the federal credit, to 36 percent. In addition, Vermont got rid of all its itemized deductions, though it did create a new 5 percent credit for charitable giving. And Vermont also chose not to have a pass-through deduction.

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[32] Auxier, R., Rueben, K., Sayed, S., & Charleston, D. (2020). *What Colorado Can Learn from States that Recently Transitioned from FTI to AGI*. Tax Policy Center.

[33] H. 16, 2018 Reg. Sess. (Vermont 2018), https://legislature.vermont.gov/bill/status/2018.1/H.16

Conclusion

A substantial number of stakeholders have taken great interest in the Task Force's discussions on the issues above. Values related to equitable treatment of tax law, responsibility to balance state and local budgets, and delivery of efficient government services have all been debated and hopefully summarized here for the Legislative Oversight Committee Concerning Tax Policy to consider.