



FOREIGN SOURCE INCOME EXCLUSIONS FOR C CORPORATIONS AND EXPORT PARTNERSHIPS

EVALUATION SUMMARY | SEPTEMBER 2022 | 2022-TE36

EXPENDITURE	Foreign Source Income Exclusion for C Corporations	Foreign Source Income Exclusion for Export Partnerships
TAX TYPE	Income	Income
YEAR ENACTED	1985	1993
REPEAL/EXPIRATION DATE	None	None
REVENUE IMPACT	\$81.7 million (Tax Year 2018)	Could not determine
NUMBER OF TAXPAYERS	1,316	Could not determine

KEY CONCLUSION: The Foreign Source Income Exclusion is likely being used by a substantial portion of C corporations with foreign source income, but according to Department of Revenue staff, many taxpayers calculate the amount of their exclusion incorrectly because it is complicated. The Export Partnership Exclusion provides a method of excluding foreign source income for some partnerships, but it is not available for all partnerships with foreign source income. Additionally, it appears to be claimed infrequently and eligible taxpayers may not be aware of

WHAT DO THESE TAX EXPENDITURES DO?

FOREIGN SOURCE INCOME EXCLUSION FOR C CORPORATIONS [Section 39-22-303(10), C.R.S.]—Allows C-corporations with foreign source income that claim a federal deduction or credit for foreign taxes paid to exclude some of their foreign source income when calculating their Colorado taxable income.

FOREIGN SOURCE INCOME EXCLUSION FOR EXPORT PARTNERSHIPS [Section 39-22-206, C.R.S.]—Allows the partners of export partnerships to exclude from their gross income for Colorado income tax purposes their distributive share of any partnership income or gain that is considered foreign source income for federal income tax purposes.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exclusions do not explicitly state their purpose; therefore, we considered the following potential purposes:

FOREIGN SOURCE INCOME EXCLUSION FOR C CORPORATIONS—To establish how Colorado taxes foreign source income of C-corporations that are doing business in Colorado.

FOREIGN SOURCE INCOME EXCLUSION FOR EXPORT PARTNERSHIPS—To treat partnership businesses similarly to corporations with regard to foreign source income.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing statutory purposes and performance measures for the exclusions.

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EVALUATION RESULTS

WHAT ARE THE TAX EXPENDITURES?

This report covers the evaluation of two tax expenditures that exclude non-U.S. income (referred to as foreign source income throughout this report) from Colorado income tax: the Foreign Source Income Exclusion for C Corporations (Foreign Source Income Exclusion) [Section 39-22-303(10), C.R.S.] and the Foreign Source Income Exclusion for Export Partnerships (Export Partnership Exclusion) [Section 39-22-206, C.R.S.].

Foreign source income is defined by reference to the Internal Revenue Code [26 USC 862] and includes, but is not limited to, the following types of income from outside of the United States: interest; dividends; compensation for labor and services; rental or royalties from property, including intangible property such as patents, copyrights, trade brands, secret processes and formulas, franchises, and trademarks; income from the sale or exchange of real property, and sale or exchange of inventory. Federal law creates a complex system of tax laws relating to the taxation of income generated outside of the United States, which continues to evolve as Congress passes new laws regarding the taxation of foreign source income. Since Colorado generally conforms to the Internal Revenue Code and uses federal taxable income as the starting point for calculating Colorado taxable income, changes to federal law relating to foreign source income may also impact Colorado's tax base, including the two exclusions covered in this report.

FOREIGN SOURCE INCOME EXCLUSION

Taxpayers that have income from business activity that is taxable in Colorado and in other jurisdictions (e.g., other states, other countries) are required to apportion their income when determining their Colorado taxable income. Apportionment of income is the way that states determine how much of a taxpayer's income should be subject to tax in the state. Statute [Section 39-22-303.6(2) and (4)(a), C.R.S.] provides that taxpayers must apportion their income to Colorado using the following formula:

$$\text{Apportionable Income} \times \frac{\text{Total Receipts of Taxpayer in Colorado during the Tax Period}}{\text{Total Receipts of Taxpayer Everywhere during the Tax Period}}$$

Apportionable income is federal taxable income after Colorado additions and subtractions. For purposes of apportionment, receipts means “all gross receipts of the taxpayer that are not allocated... and that are received from transactions and activity in the regular course of the taxpayer's trade or business...” [Section 39-22-303.6(1)(d), C.R.S.]. For example, if a taxpayer with only U.S. operations has \$100 of apportionable income, \$500 of receipts in Colorado, and \$1,000 of receipts everywhere (including the \$500 in Colorado), they would apportion \$50 of their income to Colorado.

When apportioning income, the Foreign Source Income Exclusion allows C- corporations to exclude some amount of foreign source income when determining Colorado taxable income. Additionally, the foreign income exclusion amount is subtracted from the total receipts of the taxpayer everywhere during the tax period (i.e., the denominator of the apportionment formula). Therefore, for C-corporations that claim the Foreign Source Income Exclusion, the apportionment formula used to establish Colorado taxable income is as follows:

$$\left(\begin{array}{l} \text{Apportionable Income} \\ - \text{Foreign Source Income Exclusion} \end{array} \right) \times \frac{\text{Total Receipts of Taxpayer in Colorado during the Tax Period}}{\begin{array}{l} \text{Total Receipts of Taxpayer Everywhere} \\ \text{during the Tax Period} \\ - \text{Foreign Source Income Exclusion} \end{array}}$$

The amount of the exclusion depends on whether the corporation claims a federal deduction or a federal foreign tax credit on their federal income tax return for foreign taxes paid or accrued:

- If a corporation claims a deduction for foreign taxes on its federal return, then the amount *included* in income for purposes of apportioning income to Colorado is the foreign source income minus the foreign taxes deducted at the federal level. In other words, the exclusion amount is equal to the deduction claimed for foreign taxes at the federal level.
- If a corporation claims a foreign tax credit for foreign taxes on its federal return, the exclusion amount is calculated using the following formula:

$$\text{Foreign Source Income} \times \frac{\text{Foreign Taxes Paid or Accrued}}{\left(\frac{\text{Federal Income Tax}}{\text{Federal Taxable Income}} \right) \times \text{Foreign Source Income}}$$

The exclusion amount allowed may not exceed the amount of foreign source income. This prevents the Foreign Source Income Exclusion from offsetting taxes owed on domestic sources of income.

The following example provides the calculation of a hypothetical taxpayer's Colorado taxable income assuming the taxpayer:

- Had \$1 million in federal taxable income and apportionable income, \$500,000 of which was foreign source income
- Had total receipts of \$10 million, \$3 million of which were from Colorado
- Paid \$200,000 in federal income tax
- Paid \$50,000 in foreign taxes
- Claimed the foreign tax credit on its federal return.

First, the taxpayer would calculate the Foreign Source Income Exclusion amount as follows:

$$\frac{\$500,000 \times \$50,000}{(\$200,000 / \$1,000,000) \times \$500,000} = \$250,000$$

Second, the taxpayer would incorporate the foreign income exclusion into their apportionment of income to Colorado as follows:

$$\frac{(\$1,000,000 - \$250,000) \times \$3,000,000}{\$10,000,000 - \$250,000} = \$230,769$$

In this example, the taxpayer would be liable for tax on \$230,796 in Colorado taxable income, which is \$69,231 less than if they did not use the Foreign Source Income Exclusion. Based on Colorado's 4.55 percent income tax rate, the taxpayer would save about \$3,150 in Colorado taxes by using the exclusion.

For corporations that are members of an affiliated group (e.g., parent and subsidiary corporations), the determination of the amount of the foreign income that is subject to Colorado income tax and the calculation of the Foreign Source Income Exclusion is subject to additional requirements. Under Department of Revenue (Department) Rule [1 CCR 201-2, Rule 39-22-303(11)(a)], when two or more corporations that are members of an affiliated group, as defined in statute [Section 39-22-303(12)(a), C.R.S.], qualify to file a combined report for Colorado income tax purposes, they must file a combined return. Combined reporting generally means that all corporations in the affiliated group that meet certain criteria (referred to as tests of unity) are effectively treated as a single corporation for state income tax purposes. However, statute [Section 39-22-303(8), C.R.S.] provides that if at least 80 percent of a corporation's property and payroll is located outside of the United States, that corporation must not be included in a Colorado combined return unless the corporation is located in one of the specific countries listed in statute [Section 39-22-

303(12)(b), C.R.S.] for the purpose of tax avoidance. This impacts the calculation of the Foreign Source Income Exclusion because foreign source income of members of an affiliated group that are not included in the combined return is not subject to tax in Colorado and should not be included in the calculation of the Foreign Source Income Exclusion amount.

The General Assembly created the Foreign Source Income Exclusion in 1985 with House Bill 85-1010. In 1999, with House Bill 99-1125, the General Assembly amended the formula used to calculate the excludable amount to reflect changes to the federal corporate income tax rate, which is part of the denominator of the exclusion formula when a corporation claims a foreign tax credit at the federal level. It has remained substantively unchanged since that time.

Taxpayers claim the Foreign Source Income Exclusion on line 9 of the 2021 Colorado C Corporation Income Tax Return (Form DR 0112). Taxpayers also exclude foreign source income that was subtracted on line 9 of the DR 0112 from the 2021 Schedule RF – Apportionment Schedule (Form DR 0112RF).

EXPORT PARTNERSHIP EXCLUSION

If a partnership qualifies as an export taxpayer, the Export Partnership Exclusion allows the partners to exclude from their gross income for Colorado income tax purposes their distributive share of any partnership income or gain that is considered foreign source income for federal income tax purposes. Statute [Section 39-22-206, C.R.S.] defines an export partnership as “any partnership...which sells fifty percent or more of its product or products which are produced in Colorado in states other than Colorado or in foreign countries or, if the gross receipts of such partnership are derived from the performance of services, such services are performed in Colorado by a partner or employee of the partnership and fifty percent or more of such services provided by the partnership are sold or provided to persons outside of Colorado.” A partnership is “a syndicate, group, pool, joint venture, or

other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not...a corporation or trust or estate” and that files a federal income tax return pursuant to 26 USC 6031, which is generally the Form 1065 (U.S. Return of Partnership Income). The definition of a partnership encompasses entities that may not specifically be labeled partnerships, such as multi-member limited liability companies. Generally, a partnership does not pay income tax on its income but rather passes through profits and losses to its partners, who then report the income on their respective individual income tax returns and pay tax on the income derived from the partnership.

The General Assembly created the Export Partnership Exclusion in 1993 with House Bill 93-1107. It has remained substantively unchanged since that time.

Partnerships report the Export Partnership Exclusion on Line 7 (other modifications decreasing federal income) of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). This line is used to report several other subtractions besides the Export Partnership Exclusion.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statutes do not directly state the intended beneficiaries of the tax expenditures. Based on our review of the statutory language and the legislative history of the exclusions, we inferred that the provisions were intended to benefit the following:

- FOREIGN SOURCE INCOME EXCLUSION—C-corporations that are doing business in Colorado and (1) have foreign source income on which they paid foreign taxes and (2) for federal income tax purposes claimed a deduction or foreign tax credit for foreign taxes paid or accrued.

- EXPORT PARTNERSHIP EXCLUSION—Partners of export partnerships that have foreign source income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statutes and the enacting legislation of the exclusions do not directly state the purposes of the tax expenditures. For purposes of conducting our evaluation, we considered the following potential purposes:

- FOREIGN SOURCE INCOME EXCLUSION—Based on testimony from the bill sponsor, discussions during committee hearings for the enacting legislation [House Bill 85-1010], and the operation of the exclusion, we considered a potential purpose for the exclusion: to establish how Colorado taxes foreign source income of C-corporations that are doing business in Colorado. Specifically, based on its legislative history, the exclusion appears to have been intended to define the portion of foreign source income that is taxable in Colorado and does not appear to be intended to provide preferential treatment to taxpayers with foreign source income.
- EXPORT PARTNERSHIP EXCLUSION—Based on testimony from the bill sponsor and Department staff for the enacting legislation [House Bill 93-1107], we considered a potential purpose for the exclusion: to treat partnership businesses similarly to corporations with regard to foreign source income. Specifically, the bill sponsor stated, “What we are trying to do in the bill is treat [partnerships] the same way as corporations are,” and Department staff stated, “part of that bill [House Bill 85-1010, referring to the creation of the Foreign Source Income Exclusion]...was the exclusion for foreign source income for corporations and so...this is, if you will, leveling the playing field as between corporations that’s been in effect, effective 1986, and if you happen to be doing that same type of business in partnership form, this would be leveling that playing field.” However, discussion in committee hearings for House Bill 93-1107 indicated that legislators recognized that the Export Partnership Exclusion was not designed to treat partnerships entirely the same as C-corporations but rather

provide a similar benefit that corporations receive from the Foreign Source Income Exclusion.

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

We could not definitively determine whether the Foreign Source Income Exclusion and the Export Partnership Exclusion are meeting their purposes because no purpose is provided in statute or the enacting legislation for either tax expenditure. However, we found that the Foreign Source Income Exclusion is meeting its potential purpose to some extent because it is likely being used by a substantial portion of corporations with foreign source income. However, according to the Department, many taxpayers calculate the amount of their exclusion incorrectly because the calculation is complicated. We also found that the Export Partnership Exclusion is meeting its potential purpose to a limited extent because, although it provides a method of excluding foreign income for some partnerships, it is not available for all partnerships with foreign source income, and eligible taxpayers may not be aware of the exclusion.

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

PERFORMANCE MEASURE #1: *To what extent are the Foreign Source Income Exclusion and the Export Partnership Exclusion used to calculate foreign income taxable in Colorado?*

RESULT:

Foreign Source Income Exclusion: According to Department data, a total of 1,316 corporate taxpayers claimed the Foreign Source Income Exclusion on their Colorado income tax return in Tax Year 2018. Although we were unable to determine how many taxpayers are eligible

for the exclusion, we received feedback from two CPAs who stated that, in their experience, larger corporations with foreign income are typically aware of the exclusion. However, some smaller corporations with foreign income may not be aware of it. Therefore, it is likely that a substantial portion of corporate taxpayers that have foreign source income and are doing business in Colorado are using the exclusion to calculate their Colorado taxable income.

However, Department staff also indicated that taxpayers frequently calculate the amount of their exclusion incorrectly due to its complexity and uniqueness among state foreign source income taxation policies. Since the exclusion's calculation is based on federal tax law, any changes at the federal level will result in automatic changes to Colorado's exclusion, which negatively affects the exclusion's predictability and adds more complexity to the exclusion. For example, stakeholders commented that the 2017 Tax Cuts and Jobs Act resulted in significant changes to the exclusion, despite the fact that the General Assembly has made no substantive changes to the exclusion in Colorado statute since 1999. The Department is currently revising regulations for the exclusion through its formal rulemaking process in order to address recent changes to state and federal law and clarify how taxpayers should calculate the exclusion amount, with an anticipated hearing date of December 15, 2022.

Export Partnership Exclusion: We were unable to definitively determine the extent to which the Export Partnership Exclusion is being claimed because it is not itemized on the Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). However, feedback from Department staff and stakeholders indicated that the exclusion has not likely been claimed frequently, and some eligible taxpayers may not be aware of the exclusion. According to data from the Internal Revenue Service, about 4 percent of partnerships nationally reported income from foreign transactions in Tax Year 2019. Assuming that partnerships with Colorado taxable income follow the same pattern, the Export Partnership Exclusion is likely only available to a small percentage of partnerships, particularly

since statute allows the exclusion only for those partnerships that sell at least 50 percent of their products or services out of state.

PERFORMANCE MEASURE #2: *To what extent does the Export Partnership Exclusion establish a method of taxing partners on foreign source income of partnerships that is similar to Colorado's method of taxing foreign source income of C-corporations?*

RESULT:

Although partnerships are generally not subject to federal or Colorado income tax, partnership income passes through to the partners and is then subject to income tax according to the partners' taxpayer type (e.g., individual or C-corporation). The Export Partnership Exclusion (for partnerships) is similar to the Foreign Source Income Exclusion (for C-corporations), in principle, because both exclusions allow taxpayers to exclude some portion of their foreign source income when calculating their Colorado taxable income. However, there are still some differences between Colorado's method of taxing foreign source income for partnerships and the method used for C-corporations.

First, the Export Partnership Exclusion allows eligible partnerships to exclude the entire amount of their foreign source income from Colorado taxable income. In contrast, the Foreign Source Income Exclusion allows C-corporations to exclude a variable portion of their foreign source income from Colorado taxable income, which is calculated based on the formula laid out in statute. In this sense, the Export Partnership Exclusion may provide a larger benefit to a partnership than the Foreign Source Income Exclusion would provide to a similarly situated taxpayer organized as a C-corporation.

On the other hand, the Export Partnership Exclusion is only available to partnerships that sell at least 50 percent of their products or services outside the state, while the Foreign Source Income Exclusion is available for any C-corporation with foreign source income. Therefore, the Export Partnership Exclusion may not be available for all partnerships with foreign source income, since taxpayers could theoretically sell less

than 50 percent of their products or services outside Colorado but still receive some income from business activities in other countries.

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

FOREIGN SOURCE INCOME EXCLUSION—For Tax Years 2015, 2016, and 2018, the Department estimated a total revenue impact of \$200 million for the Foreign Source Income Exclusion, or an average of \$66.6 million annually. In Tax Year 2018, the most recent year available, the Department estimated the revenue impact was \$81.7 million, which represents a direct benefit to the taxpayers that claimed the exclusion.

EXPORT PARTNERSHIP EXCLUSION—We could not quantify the revenue impact of this exclusion although its impact appears to be relatively small. Partnerships report the Export Partnership Exclusion on Line 7 (other modifications decreasing federal income) of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Partnerships use this line of the form to report the combined value of several unrelated deductions, which cannot be disaggregated for analysis. Since data was not available, we asked the Department whether they had information on the frequency with which the deduction was claimed and the potential revenue impact to the State, and Department staff reported that they do not believe this deduction is claimed frequently because during manual reviews of individual returns, they did not see that it was claimed often. Additionally, we spoke with two CPAs, and one was aware of the exclusion but had not seen it used, and the other was not aware of the exclusion and could not identify a specific type of partnership that would use it.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Overall, if the tax expenditures were repealed, corporations and export partnerships with foreign source income would no longer receive a state tax benefit on foreign source income. The specific benefit is unique to

each corporation or partner, based on the foreign income they earned, and income taxes owed, but, overall, the corporations and export partnerships would owe state income tax at the current rate of 4.55 percent on foreign source income.

FOREIGN SOURCE INCOME EXCLUSION—If the exclusion were repealed, corporations would have to include their total foreign source income when apportioning their Colorado taxable income, which would increase their Colorado tax liability. Due to data constraints and the complexity of determining and apportioning foreign source income, we could not determine the exact monetary impact to corporations that currently claim the exclusion. However, based on the Department’s reported revenue impact for Tax Year 2018 (\$81.7 million), we estimated that the average tax liability per corporation would increase by about \$60,000 to \$110,000 if the exclusion were repealed. It should be noted that because of the differences in amounts of foreign source income and final apportionment for each corporation, there are likely corporations that are less impacted and some that are more impacted than the average amount.

Stakeholders reported that the exclusion is “very important” for large multinational corporations, and eliminating the exclusion would increase their Colorado tax liability, which could potentially create an economic disincentive for corporations to do business or headquarter in Colorado.

EXPORT PARTNERSHIP EXCLUSION—For export partners that claim the exclusion, they would no longer be able to deduct foreign source income on their income taxes. Because the Department does not have data on the total number of taxpayers claiming this exclusion or its revenue impact, we were unable to determine what the actual impact of eliminating this tax expenditure would be. Stakeholders reported that they were not aware of any taxpayers taking the exclusion, likely due to companies with international operations generally being organized as corporations rather than partnerships. However, there is not sufficient data on the total number of export partnerships in Colorado,

so we could not conclude on the impact to beneficiaries of this expenditure.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Although most states have tax expenditure provisions that help define how they tax foreign income, other states' approaches to taxing foreign source income vary greatly, and we did not identify any states with a provision that excludes foreign source income similarly to the Foreign Source Income Exclusion or the Export Partnership Exclusion. Some states adhere to federal law in determining the types and amount of foreign income they tax, while others have their own definitions of taxable income that result in states taxing more or less foreign income than is taxed by the federal government and by other states.

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

We did not identify any similar tax expenditures or programs available in the state.

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

The Department was not able to provide data to determine the extent to which any eligible partners (including non-resident partners, individuals, or estates or trusts) of export partnerships claim the Export Partnership Exclusion. Partnerships report the Export Partnership Exclusion on Line 7 (other modifications decreasing federal income) of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). This line is used to report several other subtractions besides the Export Partnership Exclusion. To provide the data necessary to determine if any taxpayers claimed the exclusion and its revenue impact, the Department would have to create a new reporting line on Form DR 0106 and then capture and house the data collected from that line in GenTax, its tax processing and information system, which, according to the Department, would require additional resources (see the Tax Expenditures Overview

Section of the Office of the State Auditor's Tax Expenditures Compilation Report for additional details on the limitations of Department data and the potential costs of addressing the limitations). However, because this exclusion is likely claimed infrequently, it may not be worth the additional expense to amend Form DR 0106.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH STATUTORY PURPOSES AND PERFORMANCE MEASURES FOR THE EXCLUSIONS. As discussed, statute and the enacting legislation for the exclusions do not state the exclusions' purposes or provide performance measures for evaluating their effectiveness. Therefore, in order to conduct our evaluation, we considered the following potential purposes for the exclusions:

- FOREIGN SOURCE INCOME EXCLUSION—To establish how Colorado taxes foreign source income of C corporations that are doing business in Colorado.
- EXPORT PARTNERSHIP EXCLUSION—To treat partnership businesses similarly to corporations with regard to foreign source income.

We identified these purposes based on statute and legislative testimony. We also developed performance measures to assess the extent to which the exclusions are meeting their potential purposes. However, the General Assembly may want to clarify its intent for the exclusions by providing a purpose statement and corresponding performance measures in statute. This would eliminate potential uncertainty regarding the exclusions' purposes and allow our office to more definitively assess the extent to which the exclusions are accomplishing their intended goals.