CREDIT FOR TAXES PAID TO OTHER STATES

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE5

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

YEAR ENACTED	1937
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$185 million (CALENDAR YEAR 2015)
NUMBER OF TAXPAYERS	65,000 (CALENDAR YEAR 2015)
AVERAGE TAXPAYER BENEFIT	$2,846
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

Taxpayers filing as individuals, fiduciaries, or estates who are Colorado residents (collectively referred to herein as "residents") may subtract some or all of the income taxes they paid to other states on income earned in the other state from the taxes they owe to Colorado. Residents can claim a credit for the lessor of:

- The amount of tax paid to the other state(s), or
- A prorated share of the resident's income earned in the other state compared to the resident's Colorado taxable income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of the credit. We inferred the purpose to be to avoid double taxation for Colorado residents who earn income in and pay taxes to other states.

WHAT DID THE EVALUATION FIND?

The credit is generally accomplishing its purpose since taxpayers appear to be aware of and are using the credit to avoid double taxation on income earned in another state. Of the 43 states that have an income tax, 42 provide a credit for income taxes paid to another state.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations for this tax expenditure.

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EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Statute [Section 39-22-108(1), C.R.S.] allows Colorado residents (residents) filing as individuals, fiduciaries, or estates, to claim a credit to offset their Colorado income tax liability in proportion to the amount of their income that was earned in and taxed by another state.

A version of this credit was created in 1937 and over time, the General Assembly has modified how the credit is calculated to account for changes in how Colorado establishes taxable income. The credit has existed in its current form since 1988.

To take the credit, resident taxpayers must include the amount of the credit in the combined total of all of the nonrefundable credits reported on their Colorado tax return, submit Department of Revenue Form 104CR, which is for reporting credits, and submit a copy of the tax return for the other state.

Residents can claim the lesser of:

- The amount of tax paid to the other state(s), or
- A prorated share of the resident's income earned in the other state compared to the resident's Colorado taxable income.

For example, a resident earned $100,000 in taxable income, $90,000 was earned in Colorado and $10,000 was earned in State A. The resident paid $500 in income taxes to State A on the $10,000 that was earned in that state. The Colorado credit would be calculated as follows:

- Colorado taxable income = Taxable income from all sources = $10,000 + $90,000 = $100,000

- Colorado income tax before credit = Colorado taxable income x 4.63% (Colorado's income tax rate) = $100,000 x 4.63% = $4,630

- Prorated share of Colorado income taxes attributed to State A income = Colorado Income Tax x State A Income/Colorado taxable income = $4,630 x $10,000/$100,000 = $463

- Credit available = lesser of the prorated Colorado tax liability ($463) or the amount of taxes paid to State A ($500) = $463

Because the credit only reduces residents' Colorado tax liability to the extent that out of state income is taxed in Colorado, residents who earn income in states with higher tax rates than Colorado receive credits less than the total tax they paid to the other state. Conversely, residents who earn income in states with lower tax rates than Colorado can only receive credits up to the amount they actually paid to the other states. If the resident in the above example had only been taxed $300 by State A, the available credit would be $300 (the lesser of $463 and $300). This prevents Colorado from subsidizing the taxpayer for the higher income tax they pay to other states and prevents taxpayers from receiving a windfall in excess of the taxes they actually pay to lower tax states.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of this expenditure. Based on the statutory language of the expenditure and Colorado's tax structure, we inferred that the intended beneficiaries of this credit are primarily individuals who are Colorado residents and who earn taxable income in other states and pay income taxes on that income to the other states.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this expenditure. We inferred that the purpose is to avoid double taxation for residents who earn income in and pay taxes to other states.

To determine the purpose of the credit, we reviewed Department of Revenue taxpayer guidance documents, expenditure reviews conducted by other states, and secondary legal publications. These sources indicated the purpose of this type of credit as avoiding state-level double taxation.

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

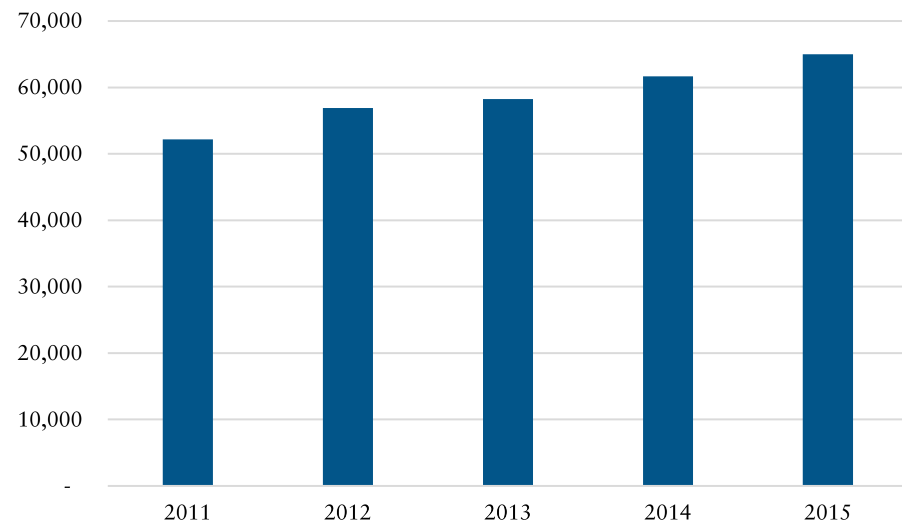
We determined that this credit is generally accomplishing its purpose since residents are aware of it and using it as intended to avoid double taxation on income earned in other states.

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

PERFORMANCE MEASURE: *To what extent are Colorado taxpayers using the credit to avoid double taxation?*

RESULT: On average, between Tax Years 2011 and 2015, approximately 59,000 taxpayers claimed the credit annually. EXHIBIT 1.1 shows the number of residents claiming the credit each year, which has increased about 20 percent over the 5-year period.

EXHIBIT 1.1. TOTAL NUMBER OF RESIDENT TAXPAYERS CLAIMING CREDIT FOR TAXES PAID TO OTHER STATES TAX YEARS 2011-2015



SOURCE: Office of the State Auditor analysis of Department of Revenue individual taxpayer data for Tax Years 2011-2015.

Furthermore, it appears that eligible taxpayers are generally aware of the credit. According to representatives from the Colorado Society of Certified Public Accountants, taxpayers most commonly qualify for the credit because they paid taxes on business investment income, royalty income earned on mineral assets owned in another state, or income from property they rent or sold in another state or because they worked in another state while maintaining full time residency in Colorado. Tax preparers in the state are well aware of the credit, so eligible taxpayers who use a tax preparer are very likely to take advantage of the credit. Also, for taxpayers who prepare their own taxes, Department of Revenue forms provide clear notice of the availability of the credit and instructions for how to calculate and claim it. We attempted to determine the number of taxpayers who were eligible to claim the credit to assess how often it is being used. However, we did not identify adequate sources of data to reliably determine how many taxpayers could have claimed it.

Although the credit generally appears to be accomplishing its purpose, it may not eliminate double taxation in some situations. Specifically, because the credit is limited to income taxes paid to another state from sources within that state, if a taxpayer has income that is not tied to a specific location, such as investment income, and is considered a resident of both Colorado and the other state, then both states could tax the income. Colorado statute defines a "resident individual" as a person domiciled in Colorado who maintains a permanent place of abode within this state and who spends more than 6 months of the taxable year in Colorado [Section 39-22-103(8), C.R.S.]. However, other states may have more inclusive residency laws, which could result in taxpayers with multiple states of residence. In practice, the Department of Revenue reports that taxpayers rarely have multiple states of residence, though specific data on Colorado residents who are also residents of other states were not available.

Additionally, the credit may not eliminate double taxation if differences exist regarding how Colorado determines where a taxpayer earned the income compared to how the taxing state determines location. According to state regulations, Colorado's determination of earning location controls for purposes of the credit. For example, State A may determine that $10,000 was earned within its borders, but under Colorado laws only $9,000 was earned in State A. Thus, the credit would be calculated based on the amount of taxes paid on $9,000, as determined by Colorado.

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

We estimate that beneficiaries of the credit saved, in total, about $176.4 million annually during Tax Years 2011 through 2015, or about $3,000 per taxpayer. The State incurred a direct revenue loss of the same amount. These estimates are based on Department of Revenue tax return data.

EXHIBIT 1.2 provides a breakout by year of the total amount of the credit claimed compared to the number of individual taxpayers who claimed the credit.

EXHIBIT 1.2. TOTAL AMOUNT CLAIMED AND NUMBER OF INDIVIDUAL CLAIMANTS TAX YEARS 2011 TO 2015			
	TOTAL AMOUNT CLAIMED	NUMBER OF CLAIMANTS	AMOUNT CLAIMED PER TAXPAYER
2011	$147,152,300	52,169	$2,821
2012	$193,675,200	56,921	$3,403
2013	$167,279,100	58,253	$2,872
2014	$189,019,900	61,666	$3,065
2015	$185,038,400	65,021	$2,846
Percent change 2011 to 2015	20%	20%	1%
Average 2011 to 2015	$176,433,000	58,806	$3,000

SOURCE: Office of the State Auditor analysis of Department of Revenue individual taxpayer data for Tax Years 2011 to 2015.

In addition, we estimate that the State receives approximately $1.1 million in additional sales tax revenue due to taxpayers spending the money they save by applying the credit. To calculate this estimate, we used data on average state sales taxes paid by taxpayers at various income levels from the Department of Revenue's *2016 Tax Profile and Expenditure Report*. We multiplied the total credit amounts for each taxpayer who took the credit by the average sales taxes paid (as a percentage of total income) for taxpayers with similar income and totaled the amounts to arrive at our estimate.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Federal law allows states to tax a resident's entire income no matter where the resident earns it and a nonresident's income if the individual has a connection (also known as a "nexus") to the state, such as the sale of goods or real estate located within the state. Therefore, Colorado would be permitted to tax income from other states under federal law.

If this credit were eliminated, a resident's income would be taxed in the state where the income was earned and by Colorado, creating an economic disincentive for residents to earn income outside the state and remain Colorado residents. Based on our review of state taxpayer data, the average taxpayer who took the credit during Tax Years 2011 through 2015 had an average taxable income of about $332,130 and a total Colorado tax liability of about $12,600, before applying the average $3,000 credit. Thus, eliminating the credit would represent about a 31 percent Colorado tax increase for these residents.

Furthermore, the state-level taxes on the income earned in other states would increase sharply. To illustrate the potential impact, EXHIBIT 1.3 shows the state-level tax burden for several hypothetical resident taxpayers with and without the credit.

EXHIBIT 1.3. EXAMPLE STATE TAX LIABILITIES OF COLORADO RESIDENTS EARNING INCOME IN COLORADO AND STATE A

	TAXPAYER #1	TAXPAYER #2	TAXPAYER #3
Colorado Income	$0	$100,000	$200,000
State A Income	$50,000	$200,000	$100,000
Colorado Taxes[1]	$2,315	$13,890	$13,890
State A Taxes[2]	$2,393	$10,942	$5,242
Credit Amount[3]	$2,315	$9,260	$4,630
State-level Tax Liability with Credit	$2,393	$15,572	$14,502
State-level Tax Liability without Credit	$4,708	$24,832	$19,132
Percent State-level Tax Increase without Credit	97%	59%	32%

SOURCE: Office of the State Auditor analysis.
[1]Colorado income taxes for 2018 are 4.63 percent of Colorado and State A income combined.
[2]State A income taxes for non-residents in the examples above are based on Kansas income taxes of 5.7 percent of income above $30,000, plus $1,252.50 (totals in the exhibit are rounded to the nearest dollar).
[3]Credit amount is calculated as provided by Section 39-22-108, C.R.S. Because Colorado's effective tax rate is lower than State A for each taxpayer, the credit amount is equivalent to 4.63 percent of the State A income.

Since a taxpayer earning a greater percentage of their income in another state would be more severely impacted if the credit were eliminated, this may be an indication that this credit reduces potential disincentive for Colorado residents to work in other states by ensuring that taxpayers with a presence in another state are not subject to additional taxation.

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

Of the 43 states that impose income taxes, 42 offer a credit for income taxes paid to another state. States calculate the amount of the credit in one of three ways:

- Multiplying the resident's state tax liability by the ratio of income taxes by the other state to the resident's taxable income;
- Multiplying the income taxed by both states by the resident state rate on such income, as done in Colorado; or
- Determining the difference between the resident tax calculated by first including and then excluding the income subject to tax in both states.

A handful of states, such as California, Georgia, and Iowa, only allow this credit if the state where the income was earned also provides a credit.

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

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

The Department of Revenue was not able to extract and provide us with data for the fiduciaries and estates that claimed the credit. Currently, fiduciary and estate taxpayers provide the name of the other state, amount of the credit, and copy of the tax return submitted to the other state when claiming the credit. According to the Department of Revenue, although GenTax, its tax processing and information system, captures the amount of the credit and the name of the state, this information is difficult and time consuming to extract. Due to this limitation, our analysis and the figures provided on the number of taxpayers who took the credit and the revenue impact do not include fiduciaries and estates. However, programming GenTax to facilitate the extraction of these data may not be a cost effective use of state resources since the fiduciary taxpayers comprise less than 1 percent of the State's tax collections, and estate taxpayers are not separately reported and would therefore have a small impact on our analysis (see the Tax Expenditures Overview section of this Compilation Report for details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this tax expenditure.