CORPORATE DEDUCTION FOR DIVIDENDS UNDER SECTION 78 OF THE INTERNAL REVENUE CODE

EVALUATION SUMMARY

JULY 2019
2019-TE24

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Less than $51.4 million TAX YEAR 2015
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes, to some extent

WHAT DOES THIS TAX EXPENDITURE DO?

This deduction allows corporations that have dividends from foreign subsidiaries added to their federal taxable income under Section 78 of the Internal Revenue Code (IRC 78) to deduct the amount treated as IRC 78 dividends from their federal taxable income when computing Colorado taxable income. IRC 78 is a federal provision intended to prevent a taxpayer from receiving a double benefit (i.e., an indirect foreign tax credit and an indirect deduction for foreign taxes paid by a foreign subsidiary) at the federal level. Since Colorado does not provide a foreign tax credit, there is no double benefit at the state level that needs to be mitigated by a gross-up provision.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. We inferred that the purpose is to neutralize the effect of IRC 78 for state tax purposes.

WHAT DID THE EVALUATION FIND?

We determined that this deduction is meeting its purpose, although some potentially eligible taxpayers and small local and regional accounting firms may not be aware of it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

CORPORATE DEDUCTION FOR DIVIDENDS UNDER SECTION 78 OF THE INTERNAL REVENUE CODE

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Corporate Deduction for Dividends Under Section 78 of the Internal Revenue Code (IRC 78 Deduction) allows corporations to deduct for Colorado income tax purposes foreign source dividends that must be included in federal taxable income under Section 78 of the Internal Revenue Code (IRC 78) [Section 39-22-304(3)(j), C.R.S.]. House Bill 77-1402 created the IRC 78 Deduction in 1977, and it has remained unchanged since then.

Federal laws [26 USC 901 and 960] allow U.S. corporations that have certain foreign subsidiaries to claim a federal indirect foreign tax credit for foreign taxes that were paid by the foreign subsidiary to a foreign government when the U.S. corporation is deemed to have received an income distribution from its foreign subsidiary. This is a "deemed" income distribution to prevent tax avoidance, and the distribution is considered to have occurred when the foreign entity has income, even if an actual distribution did not occur. This provision prevents income that a U.S. parent corporation is deemed to have received through a foreign subsidiary from being taxed by both the foreign government and the United States. However, to prevent corporations from receiving a double benefit: (1) an indirect foreign tax credit for taxes deemed paid and (2) an indirect tax deduction for taxes that were paid by the foreign subsidiary, IRC 78 requires that a U.S. corporation claiming an indirect foreign tax credit include in its federal taxable income the amount of foreign taxes it is deemed to have paid, effectively eliminating the benefit of the indirect deduction.

EXHIBIT 1.1 demonstrates the calculation of the federal tax liability for a hypothetical U.S. corporate taxpayer that has a deemed income distribution from a foreign subsidiary, claims the indirect foreign tax credit for taxes deemed paid, and is subject to IRC 78.

EXHIBIT 1.1.
CALCULATION OF FEDERAL TAX LIABILITY FOR HYPOTHETICAL TAXPAYER THAT HAS DEEMED INCOME DISTRIBUTION, CLAIMS THE FOREIGN TAX CREDIT, AND IS SUBJECT TO IRC 78

FOREIGN SUBSIDIARY		
Foreign Income Before Tax	$500,000	
Foreign Income Tax Paid by Foreign Subsidiary [1]	- $125,000	
Foreign Income Deemed to be Distributed	$375,000	
U.S. CORPORATION		
U.S. Source Income		$1,000,000
Foreign Income Deemed Distributed from Foreign Subsidiary		+ $ 375,000
Federal Taxable Income Before IRC 78 Dividend		$1,375,000
IRC 78 Dividend		+ $ 125,000
Federal Taxable Income After IRC 78 Dividend [2]		$1,500,000
Federal Tax Liability (Assume 21% Rate)		$ 315,000
Indirect Foreign Tax Credit Under 26 USC 960 for Taxes Deemed Paid		- $ 125,000
Federal Tax Liability After Foreign Tax Credit		$190,000

SOURCE: Office of the State Auditor analysis of federal tax laws.
[1] This is the indirect tax deduction that the U.S. corporation receives for taxes paid by the foreign subsidiary to the foreign government.
[2] This is the starting point for calculating Colorado taxable income.

Although the IRC 78 requirements prevent a double tax benefit at the federal level, because Colorado does not offer a foreign tax credit and uses federal taxable income (after the IRC 78 Dividend, as shown in EXHIBIT 1.1.) as the starting point for calculating Colorado taxable income for corporations, without an adjustment, IRC 78 would increase taxpayers' Colorado taxable income. The IRC 78 Deduction prevents this by allowing taxpayers to deduct for state income tax purposes, the amount that they included in their federal taxable income due to IRC 78.

Corporations claim this deduction on Line 13 (Other Subtractions) of the Colorado C-Corporation Income Tax Return (Form DR 0112). Because IRC 78 income generally only applies to corporations at the federal level, the IRC 78 Deduction is only available for corporations.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the IRC 78 Deduction. Based on the statutory language of the deduction and interactions between the federal and Colorado income tax systems, we inferred that the intended beneficiaries are U.S. corporations that are doing business in Colorado, have foreign subsidiaries, and have IRC 78 dividends included in their federal taxable income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. Based on the statutory language of the deduction and interactions between the federal and Colorado income tax systems, we inferred that the purpose of this deduction is to neutralize the effect of IRC 78 for state tax purposes. This is a common structural provision in states that levy a corporate income tax.

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

We determined that this deduction is meeting its purpose, although some Colorado-based companies with foreign subsidiaries and smaller local and regional accounting firms may not be aware of it.

Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the IRC 78 Deduction is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent are corporations using the deduction to prevent state taxation of IRC 78 dividends that are included in their federal taxable income?*

RESULT: We found evidence that taxpayers are likely using the IRC 78 Deduction, although we lacked information from the Department of

Revenue to quantify the extent to which it is used. Specifically, we were unable to determine the number of corporations that claimed this deduction because the Colorado C-Corporation Income Tax Return (Form DR 0112) combines the IRC 78 Deduction with several other deductions on a line for "Other Subtractions." However, in Tax Year 2015 (the most recent year that complete data were available), almost 50,000 corporations filed income tax returns in Colorado. Of those, approximately 2,800 included a deduction amount on the line for "Other Subtractions." Therefore, up to 6 percent of corporations may have claimed the deduction, although we lacked the data necessary to say definitively the proportion of these taxpayers that took the IRC 78 Deduction.

In addition, we consulted with several corporations in Colorado with foreign subsidiaries and Certified Public Accountants (CPAs) that work with U.S. corporations with foreign subsidiaries and found that large CPA firms and CPAs that specialize in international taxation are well aware of the deduction and frequently claim it on their clients' tax returns. However, some corporations that we contacted that may be eligible for the IRC 78 Deduction and several smaller local and regional CPA firms were not aware of it. Although we lacked the data to say definitively the number of corporations that claimed the deduction, based on our interviews with these stakeholders, it appears that some eligible corporations may not claim it.

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

The Department of Revenue was unable to provide specific data on the total amount claimed under the IRC 78 Deduction and the revenue impact attributable to those claims. However, Department of Revenue data indicate that the revenue impact for corporations would be less than $51.4 million for Tax Year 2015, which was the total amount reported on the "Other Subtractions" line of the Colorado C-Corporation Income Tax Return (Form DR 0112). This line includes the IRC 78 Deduction plus nine other income tax deductions. Based on our conversations with CPAs and due to the fact that it is likely that the other deductions included on the reporting line have a significant revenue impact as well, we would expect the amount attributable to the IRC 78 Deduction to be less than $51.4 million.

In addition, recent changes to federal law may have an impact on the amount of IRC 78 Deductions taxpayers claim. Specifically, the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97] required corporations with accumulated foreign earnings to make a deemed repatriation of the income to the United States in Tax Year 2017, or Tax Year 2018 for fiscal year taxpayers, which increased foreign dividends and income and consequently, IRC 78 dividends. Therefore, it is possible that this change caused an increase in the revenue impact of the IRC 78 Deduction for Tax Years 2017 and 2018. However, we lacked data to determine how much it may have increased.

Additionally, prior to the Tax Cuts and Jobs Act, federal law [26 USC 902] also allowed an indirect foreign tax credit for U.S. corporations that owned at least 10 percent of the voting stock of a foreign corporation from which they received dividends. When a taxpayer claimed an indirect tax credit under 26 USC 902, they were required to include IRC 78 dividends in their federal taxable income. The Tax Cuts and Jobs Act repealed the indirect foreign tax credit available under 26 USC 902. EXHIBIT 1.2 demonstrates the calculation of the federal tax liability prior to the Tax Cuts and Jobs Act for a hypothetical U.S. corporate taxpayer that had a deemed income distribution from a foreign subsidiary and a dividend distribution from a foreign affiliate of which it owned 10 percent, claimed the indirect foreign tax credits for taxes deemed paid, and was subject to IRC 78. As shown in the table, the indirect foreign tax credit under 26 USC 902 increased the amount of IRC 78 dividends prior to its repeal, so in future tax years, the taxpayer would see a corresponding decrease in IRC 78 dividends.

EXHIBIT 1.2.
INDIRECT FOREIGN TAX CREDITS
PRE-TAX CUTS AND JOBS ACT

FOREIGN SUBSIDIARY (26 USC 960)		FOREIGN AFFILIATE–10% OWNERSHIP (26 USC 902–REPEALED IN TAX CUTS AND JOBS ACT)	
Foreign Income Before Tax	$500,000	Foreign Income Before Tax [1]	$200,000
Foreign Income Tax Paid by Foreign Subsidiary	- $125,000	Foreign Income Tax Paid by Foreign Subsidiary [1]	- $50,000
Foreign Income Deemed to be Distributed	$375,000	Foreign Dividends Distributed [1]	$150,000

U.S. CORPORATION	
U.S. Source Income	$1,000,000
Foreign Income Deemed Distributed from Foreign Subsidiary	+ $ 375,000
Foreign Dividends Distributed from Foreign Affiliate	+ $ 150,000
Federal Taxable Income Before IRC 78 Dividend	$1,525,000
IRC 78 Dividend	+ $ 175,000
Federal Taxable Income After IRC 78 Dividend	$1,700,000
Federal Tax Liability (Assume 21% Rate)	$ 357,000
Indirect Foreign Tax Credits Under 26 USC 960 and 26 USC 902 for Taxes Deemed Paid	- $ 175,000
Federal Tax Liability After Foreign Tax Credit	$182,000

SOURCE: Office of the State Auditor analysis of federal tax laws.
[1] This assumes the foreign income, foreign taxes, and dividends have been prorated based on the U.S. Corporation having 10 percent ownership of the foreign affiliate.

In addition, the Tax Cuts and Jobs Act altered the calculation for how U.S. corporations determine the amount of taxes they are deemed to have paid for the purposes of the remaining indirect tax credit under 26 US 960, which may change the amount of IRC 78 dividends U.S. corporations are required to include in their income. However, it is unclear how these changes to federal law will impact the amount of IRC 78 dividends included in federal taxable income, or the amount of IRC 78 Deductions claimed in Colorado.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this deduction were eliminated, it could result in taxpayers incurring a larger Colorado tax liability when they have IRC 78 dividends included in their federal taxable income. EXHIBIT 1.3 shows the Colorado tax liability of a hypothetical corporate taxpayer with and without the IRC 78 Deduction.

EXHIBIT 1.3.
TAXPAYER SCENARIOS WITH AND WITHOUT THE IRC 78 DEDUCTION

FEDERAL TAXABLE INCOME CALCULATION	
U.S. Source Income	$1,000,000
Income Deemed Received from Foreign Subsidiary	+ $375,000
Section 78 Dividend	+ $125,000
Federal Taxable Income	$1,500,000
Federal Tax (Federal Taxable Income x 21 Percent)	$315,000
Foreign Tax Credit	- $125,000
Federal Tax Due	= $190,000

COLORADO TAX CALCULATION		
	WITH IRC 78 DEDUCTION	WITHOUT IRC 78 DEDUCTION
Federal Taxable Income[1]	$1,500,000	$1,500,000
Colorado IRC 78 Deduction	- $125,000	
Colorado Taxable Income	= $1,375,000	$1,500,000
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$63,663	$69,450

SOURCE: Office of the State Auditor analysis of federal and State tax provisions.
[1] For simplification purposes, this example assumes that the taxpayer is not required to apportion income and does not take into account other modifications under Section 39-22-304, C.R.S., or Article 22, C.R.S., including the foreign income exclusion available under Section 39-22-303(10), C.R.S.

If the IRC 78 Deduction is not taken, the corporation in this example would incur a $5,787 (9.1 percent) higher Colorado tax liability.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states (excluding Colorado) and District of Columbia that have a corporate income or gross receipts tax, 43 (93 percent) have a provision that allows IRC 78 dividends to be deducted or excluded from income or gross receipts.

In addition, states that do not have provisions allowing the deduction of the amount added to federal income under IRC 78 are limited in their ability to tax IRC 78 dividends based on two U.S. Supreme Court cases:

- In *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance* (505 U.S. 71, 1992), the U.S. Supreme Court held that it is a violation of the Foreign Commerce Clause of the U.S. Constitution if a state allows a deduction for dividends received from domestic corporations, but not from foreign corporations because it treats dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries. Federal law [26 USC 78] provides that IRC 78 dividends are treated as foreign dividends received by a U.S. corporation.

- In *F. W. Woolworth Co., v., Taxation and Revenue Department of New Mexico* [458 U.S. 354, 1982], the U.S. Supreme Court held that it is a violation of the Due Process Clause of the U.S. Constitution if a state taxes IRC 78 dividends included in a U.S. corporation's federal taxable income if the U.S. corporation does not have a unitary relationship with the foreign subsidiary from which the IRC 78 dividends arose. Without this unitary relationship, the state lacks sufficient connection with the foreign subsidiary to tax the IRC 78 dividends. In order to have a unitary relationship, the Supreme Court stated the businesses must be functionally integrated, have centralized management, and achieve economies of scale.

Based on these cases, states without an IRC 78 dividends deduction or exclusion may lack legal authority to tax IRC 78 dividends if (1) the state has a dividends received deduction for domestic dividends or (2) the U.S. corporation with IRC 78 dividends does not have a unitary relationship with the foreign affiliate from which the IRC 78 dividends arose.

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

Colorado has an income exclusion for some foreign source income [Section 39-22-303(10), C.R.S.] if the taxpayer claims a foreign tax credit for federal tax purposes. This provision allows corporations to exclude some of their foreign source income from Colorado taxable income. The amount of income that can be excluded is determined by a statutory formula [Section 39-22-303(10)(b)(III), C.R.S.]. The foreign income exclusion does not exclude IRC 78 dividends from Colorado taxable income, so this tax expenditure does not overlap with the IRC 78 Deduction.

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

The Department of Revenue was not able to provide us with data for the corporations that claimed the IRC 78 Deduction. Corporations claim the deduction on Line 13 (Other Subtractions) of the Colorado C-Corporation Income Tax Return (Form DR 0112), which also includes several other deductions. Taxpayers are required to submit explanations for the deductions taken as other subtractions, but these explanations are not captured by GenTax, the Department of Revenue's tax processing and information system. Due to these limitations, we were unable to determine how many corporations claimed this deduction and the revenue impact for corporations claiming it.

To address these limitations, the Department of Revenue would have to create a new reporting line on the Form DR 0112 and then capture and house the data collected on that line in GenTax, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2018 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the IRC 78 Deduction.