DEDUCTION FOR WAGES & SALARIES DUE TO IRC 280C

EVALUATION SUMMARY

APRIL 2019
2019-TE8

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1979
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

WHAT DOES THIS TAX EXPENDITURE DO?

The Deduction for Wages & Salaries Due to Internal Revenue Code Section 280C (IRC 280C Deduction) allows C-corporations and individuals with income from S-corporations to modify their federal taxable income for purposes of determining state taxable income by deducting wage and salary expenses that are not deductible for federal tax purposes due to IRC 280C. IRC 280C limits the deduction of expenses that are used as the basis for federal credits referenced by IRC 280C.

WHAT DID THE EVALUATION FIND?

The IRC 280C Deduction is generally meeting its purpose since it appears that taxpayers are using it to offset the impact of IRC 280C on Colorado Taxable Income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this deduction. We inferred that the purpose was to neutralize the effect of IRC 280C on the deductibility of wage and salary expenses for the purposes of determining Colorado taxable income.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether sole proprietors, partnerships, and limited liability companies should also be allowed to claim the deduction. Additionally, due to changes to the Federal Tax Code since the deduction was created, the General Assembly may want to determine whether limiting the deduction to only wages and salaries and only amounts disallowed from deduction by IRC 280C meets its intent.

DEDUCTION FOR WAGES & SALARIES DUE TO IRC 280C

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Deduction for Wages and Salaries Due to Internal Revenue Code 280C (IRC 280C Deduction) [Sections 39-22-304(3)(i), 322, and 323, C.R.S.], allows C-corporations and S-corporations to deduct for state tax purposes, wage and salary expenses that are not allowed to be deducted from federal taxable income under Internal Revenue Code, Section 280C (IRC 280C).

In 1977, the U.S. Congress passed IRC 280C as part of a broader bill that established federal employment tax credits. Under IRC 280C, taxpayers who claimed the federal employment tax credits were required to reduce the amount of wage and salary expenses that they could otherwise deduct from their federal taxable income by the amount of the credit they received. It appears that Congress included IRC 280C to prevent taxpayers from receiving a double tax benefit by both receiving a credit and deducting from their taxable income the associated expenses they incurred to qualify for the credit, up to the credit amount.

For Colorado tax purposes, IRC 280C had the side effect of increasing state tax liability for taxpayers subject to its requirements. This occurred because since 1965, Colorado has used federal taxable income as the starting point when calculating Colorado taxable income. Businesses subject to IRC 280C had a higher federal taxable income because they were no longer able to deduct a portion of their wage and salary expenses when calculating their federal taxable income and would, therefore, have had a higher Colorado taxable income, since it was tied to federal taxable income. However, because Colorado does not offer the same employment credits that trigger the application of IRC 280C at the federal level, taxpayers would not receive an offsetting tax benefit for state tax purposes, resulting in higher state tax liabilities.

In 1979, the General Assembly created the IRC 280C Deduction to address the higher state tax liabilities caused by IRC 280C. The deduction applies only to C-corporations and S-corporations; it does not apply to sole proprietors, partnerships, or limited liability companies. C-corporations are subject to income tax, federally and in Colorado, at the entity-level. S-corporations are not subject to income tax at the entity-level, but rather, the income from an S-corporation passes through to the individual shareholders based on their pro-rata share of ownership in the S-corporation. Individual shareholders report their share of the S-corporation's income on their individual income tax returns. When calculating Colorado taxable income, the deduction allows C-corporations and shareholders of S-corporations to deduct the wage and salary expenses that were disallowed from being deducted when calculating federal taxable income due to IRC 280C. This has the effect of adjusting taxpayers' Colorado taxable income to be equivalent to what it would have been if not for IRC 280C. EXHIBIT 1.1 illustrates the application of the deduction.

EXHIBIT 1.1. APPLICATION OF THE IRC 280C DEDUCTION FOR THE PURPOSES OF CALCULATING FEDERAL AND COLORADO TAXABLE INCOME

Federal Gross Income

\-

Federal Deductions

\+

Amount not deductible due to a credit referenced in IRC 280C

=

Federal Taxable Income

\-

Deduction for wages and salaries not deductible from federal taxable income due to IRC 280C

=

Colorado Taxable Income

SOURCE: Office of the State Auditor analysis of federal and Colorado taxable income calculations.

The deduction has not been modified since its enactment; however, Congress has made several additions to IRC 280C since 1977, so that it now disallows deductions for expenses related to 12 different federal credits, some of which are not limited to wage and salary expenses. At the state level, the IRC 280C Deduction applies to expenses related to these federal credits as well, but only to the extent that they are for wages and salaries.

EXHIBIT 1.2 lists the federal credits referenced in IRC 280C and indicates the types of expenses that taxpayers are disallowed from deducting from federal taxable income due to IRC 280C. For state tax purposes, Section 39-22-304(3)(i), C.R.S., allows taxpayers to claim the IRC 280C Deduction for all of the credits indicated in the exhibit, but only to the extent that the amount disallowed from deduction at the federal level included wages and salaries. Other business expenses, such as materials and overhead, that are disallowed from being deducted from federal taxable income for several credits under IRC 280C do not qualify for the deduction.

EXHIBIT 1.2. FEDERAL CREDITS REFERENCED BY IRC 280C AS OF JANUARY 2019		
CREDIT NAME	TITLE 26 USC SECTION	TYPE OF EXPENSE DISALLOWED DUE TO IRC 280C
Indian Employment Credit	45A	Wages and salaries only
Employer Wage Credit for Employees who are Active Duty Members of the Uniformed Services	45P	Wages and salaries only
Employer Credit for Paid Family & Medical Leave	45S	Wages and salaries only
Work Opportunity Credit	51	Wages and salaries only
Empowerment Zone Employment Credit	1396	Wages and salaries only
Credit for Qualified Clinical Testing Expenses for Certain Drugs	45C	Not limited to wages and salaries
Credit for Increasing Research Activities	41	Not limited to wages and salaries
Credit for Low-Sulfur Diesel Fuel Production	45H	Not limited to wages and salaries
Mine Rescue Team Training Credit	45N	Not limited to wages and salaries
Credit for Security of Agricultural Chemicals	45O	Not limited to wages and salaries
Credit for Health Insurance Premiums	36B	Not limited to wages and salaries
Employee Health Insurance Expenses of Small Employers	45R	Not limited to wages and salaries

SOURCE Office of the State Auditor review of IRC 280C.

To claim the IRC 280C Deduction, C-corporations include the amount of the deduction on Line 13 for “Other Subtractions” on their Corporation Income Tax Return (Form DR 0112). Taxpayers also use this line for several other unrelated deductions, which they combine for tax reporting purposes. Individuals who receive income from an S-corporation may claim their pro-rata share of the deduction based on their ownership interest on Line 17, also for “Other Subtractions,” on the Subtractions from Income Schedule (Form DR 0104AD) when filing their Individual Income Tax Return (Form DR 0104). This line also combines taxpayer reporting of several other unrelated deductions.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the IRC 280C Deduction. Based on statutory language and the interaction between federal and state tax laws, we inferred that the intended beneficiaries of the deduction are C-corporations and individuals with income from S-corporations that IRC 280C does not allow to deduct a portion of their wage and salary expenses from their federal taxable income if they take the associated federal tax credits.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of the IRC 280C Deduction. Based on our review of the federal Internal Revenue Code, state statutes, legislative history, Department of Revenue taxpayer guidance, and similar statutes in other states, we inferred that the purpose is to neutralize the effect of IRC 280C as it applies to Colorado taxable income for wage and salary expenses for C-corporations and S-corporations doing business in Colorado. This is a common structural provision in states that tie their state taxable income amount to federal taxable income.

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

We found that the IRC 280C Deduction is likely meeting its purpose, although we lacked the information necessary to quantify how frequently taxpayers use it.

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

PERFORMANCE MEASURE: *To what extent are eligible taxpayers using the IRC 280C Deduction?*

RESULT: We found evidence that taxpayers are likely using the IRC 280C Deduction, although we lacked information from the Department of Revenue to quantify the extent to which it is used. Specifically, the 2018

U.S. Treasury Department's *Tax Expenditures* report estimated that, nationally, taxpayers claimed $23.7 billion in Fiscal Year 2018 for seven of the 12 federal credits referenced by IRC 280C. This indicates that Colorado taxpayers would likely continue to have a need to use the deduction to reduce their state taxable income for the amount disallowed by IRC 280C. This report did not include information for five of the credits referenced by IRC 280C, so it is likely the amount of credits claimed by taxpayers is higher than this amount. In addition, the Department of Revenue provides guidance for taxpayers specific to the deduction and its staff reported continued inquiries from taxpayers regarding the deduction's application, which indicates that Colorado taxpayers are aware of it and likely using it.

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

For C-corporations, Department of Revenue data indicate that the IRC 280C Deduction had a state revenue impact of less than $51.4 million for Tax Year 2015. Because taxpayers combine the IRC 280C Deduction with up to nine other deductions when reporting the deduction, the Department of Revenue cannot provide data specific to the total amount reported for the deduction. However, the Department of Revenue was able to provide aggregate data showing that taxpayers claimed a combined total of about $51.4 million for these 10 deductions, which is the basis of our revenue impact estimate.

For individuals who claim the IRC 280C Deduction through an S-corporation, we were unable to determine an estimated revenue impact for the deduction. Similar to C-corporations, individuals also combine the amount they claim for the deduction with several other deductions on a single reporting line; however, GenTax, the Department of Revenue's tax processing system, does not collect this information in a format that is easily extractable to allow for an aggregate total of the amount claimed for these deductions.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the IRC 280C Deduction were eliminated, corporations that have wages and salaries that cannot be deducted from federal taxable income due to IRC 280C would be unable to deduct those amounts for the purpose of determining Colorado taxable income and would, therefore, have a higher state tax liability. Eliminating the deduction could also be a relative disincentive for taxpayers to claim the federal credits subject to IRC 280C. Specifically, if the tax benefit at the federal level for the credits was less than the benefit of being able to deduct the associated expenses for state tax purposes, taxpayers may choose to forgo the federal credits.

EXHIBIT 1.3 shows the state tax liability for a hypothetical corporate taxpayer under two scenarios: (1) if the taxpayer claims a federal credit referenced by IRC 280C and claims the state deduction, and (2) if the taxpayer claims a federal credit referenced in IRC 280C and the state did not allow for the deduction.

EXHIBIT 1.3. HYPOTHETICAL STATE TAX LIABILITY WITH CURRENT IRC 280C DEDUCTION AND WITHOUT IRC 280C DEDUCTION		
	CLAIMING 280C CREDIT WITH STATE DEDUCTION	CLAIMING 280C CREDIT WITHOUT STATE DEDUCTION
Federal credit amount for credit referenced by IRC 280C	$20,000	
Salary/wage expenses used for the basis of federal credit referenced by IRC 280C	$100,000	
FEDERAL TAX CALCULATION		
Gross Income	$1,000,000	
Deduction for salary/wage expenses used for the basis of federal credit referenced by IRC 280C[1]	-$100,000	
Salary/wage expenses disallowed from deduction under IRC 280C	+$20,000	
Federal Taxable Income	=$920,000	
Federal Tax Liability (Federal Taxable Income x 21 percent) before credit	$193,200	
Federal credit	-$20,000	
Federal Tax Liability with Credit	=$173,200	
STATE TAX CALCULATION		
Federal Taxable Income	$920,000	$920,000
State deduction for wage/salaries disallowed by 280C	-$20,000	$0
Colorado Taxable Income	=$900,000	=$920,000
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$41,670	$42,596

SOURCE: Office of the State Auditor analysis of applicable state and federal tax provisions.
[1] Only includes deductible expenses used as the basis for the federal credit referenced by IRC 280C to isolate the impact of the IRC 280C Deduction. Businesses would typically deduct other expenses as well.

As EXHIBIT 1.3 demonstrates, if corporations were unable to deduct wages and salary expenses included in the calculation of the federal credits referenced in IRC 280C, then their state taxable income and tax liability would be greater due to their election to claim the federal credit.

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

Of the 43 states (excluding Colorado) and the District of Columbia that have a broad-based corporate income tax that uses federal taxable income as the starting point for calculating state taxable income, we identified 27 that provide a similar deduction for wage and salary expenses that are not deductible due to IRC 280C. Of these states, 11 provide a deduction for expenses related to federal credit provisions referenced in IRC 280C and 16 provide a deduction for only certain types of expenses disallowed from being deducted due to the federal credit provisions referenced by IRC 280C, similar to Colorado.

We did not identify any similar programs or expenditures available in Colorado.

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

The Department of Revenue was unable to provide data on the number of taxpayers who took the IRC 280C Deduction or the amount they claimed. As discussed, C-corporations claim the deduction on Line 13, "Other Subtractions," of the Corporation Income Tax Return (Form DR 0112). Taxpayers combine the total amount of nine other deductions on this line, which the Department of Revenue cannot disaggregate. In all cases, the Department of Revenue requires taxpayers to submit explanations for the deductions taken as other subtractions that are reported on Line 13. However, GenTax does not capture and compile these explanations in an easily extractable format. Similarly, individuals who claim the IRC 280C Deduction due to having income from an S-corporation claim the deduction on Line 17, also "Other Subtractions," on their Subtractions from Income Schedule (Form DR 0104AD) when filing their Individual Income Tax Return (Form DR 0104). This line also combines taxpayer reporting of several other unrelated deductions, which the Department cannot disaggregate or extract. Due to these limitations, we were unable to determine the revenue impact of the deduction and were unable to determine how many taxpayers claimed it.

To address these limitations, the Department of Revenue would have to create new reporting lines on the DR 0104, DR 0105, and DR 0112 forms and then capture and house the data collected on those lines 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 Compilations 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?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER ADDITIONAL TYPES OF TAXPAYERS SHOULD ALSO BE ELIGIBLE FOR THE IRC 280C DEDUCTION. Specifically, other than individuals who receive income from an S-corporation, the deduction is not available to taxpayers who file as individuals and receive sole proprietorship, limited liability company, or partnership income even though they are eligible for the federal credits referenced in IRC 280C and are also subject to its limitations on deducting the expenses that are the basis for these credits from federal taxable income. As a result, these taxpayers are currently subject to a higher state tax liability than C-corporations and S-corporations relative to the deduction of the applicable expenses. However, this change would likely increase the state revenue impact of the deduction, although we lacked data to quantify this potential impact.

THE GENERAL ASSEMBLY MAY WANT TO DETERMINE WHETHER THE IRC 280C DEDUCTION SHOULD BE RESTRICTED TO WAGE AND SALARY EXPENSES AND ONLY AMOUNTS THAT ARE NOT DEDUCTIBLE DUE TO IRC 280C. In 1979, the year the deduction was created, IRC 280C only restricted taxpayers from deducting "wages or salaries paid or incurred" related to the applicable federal employment credits. Statute [Section 39-22-304(3)(i), C.R.S.] limits the deduction using this same language and ties it to IRC 280C. Therefore, it is unclear if the General Assembly specifically intended to limit the deduction to wages and salaries or included this limitation to conform the language of the deduction with the original language in IRC 280C. However, since that time, the U.S. Congress has expanded IRC 280C to disallow the deduction of all types of expenses (not just wages and salaries) related to several other federal credits (see EXHIBIT 1.1 above). As a result, the IRC 280C Deduction no longer fully addresses taxpayers' increased state tax liability due to IRC 280C, which may mean that it is not fully addressing its original purpose. Of the 27 states with similar deductions, we found that 11 allow taxpayers to deduct all expenses that are disallowed by the applicable credits referenced by IRC 280C.

Similarly, the deduction does not include expenses related to the federal Employer Social Security Credit (also known as the FICA Tip Credit) under Section 26 USC 45B (IRC 45B). This credit is available to all employers (i.e., it is not limited to C- or S-corporations) who pay excess social security tax for tipped employees and, like the credits referenced in IRC 280C, taxpayers are limited from deducting these expenses if they take the federal credit. However, the deduction does not cover these expenses because they are disallowed from deduction at the federal level under IRC 45B, not IRC 280C. Congress established IRC 45B in 1993, after Colorado's IRC 280C Deduction was created, so it is unclear whether the General Assembly would have included expenses not deductible under IRC 45B as qualifying for the deduction if IRC 45B had existed at the time the deduction was established. We identified one state, Arizona, that has a similar deduction that includes IRC 45B in the expenses taxpayers can deduct when calculating state taxable income.

Expanding the types of expenses the IRC 280C Deduction applies to would increase its state revenue impact, although we lacked the necessary data to quantify this potential impact.