

Credit for Taxes Paid to Other States



OFFICE OF THE STATE AUDITOR

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C O L O R A D O

The Credit for Taxes Paid to Other States allows Colorado residents who earn income that is taxable in another state to claim an income tax credit in Colorado for the taxes they paid to the other state. We considered the purpose of the credit to be to prevent double taxation of income for Colorado residents who earn, and pay tax on, income from another state.

The credit is likely meeting its purpose because it is extensively used and avoids double taxation on income earned in other states; however, it may not eliminate double taxation in some distinct situations.

- According to stakeholders, the credit is commonly used among taxpayers who qualify; however, data does not exist on the total number of taxpayers that would qualify.
- The deduction generally prevents double taxation of income that was earned and taxed in another state.
- There may exist some distinct situations where a taxpayer does not qualify for the credit and is double taxed. For example, a taxpayer who is a resident of two or more states in the same year and earns income that is not tied to a location (e.g., dividends) or paid tax to the other state in a different year (e.g., taxes paid on retirement savings to another state in a previous year) would be double taxed on this income.

Policy Considerations

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

| | | | |
|---------------------|----------------------------------|-------------------------|------------------------|
| Tax Type: | Income tax | Year Enacted: | 1937 |
| Expenditure Type: | Credit | Repeal/Expiration date: | None |
| Statutory Citation: | Section 39-22-108, C.R.S. | Revenue Impact (2020): | \$262.6 million |

Purpose given in statute or enacting legislation? **No**



Credit for Taxes Paid to Other States

Background

The Credit for Taxes Paid to Other States allows Colorado residents who earn income that is taxable in another state to claim an income tax credit in Colorado for the taxes they paid to the other state. The credit is limited to income that is earned in a specific location (e.g., wages, rental income, royalties on oil and gas interests) and does not apply to income that is not earned in a specific location (e.g., dividends).

According to two representatives from the Colorado Society of Certified Public Accountants, taxpayers most commonly qualify for the credit because they paid taxes on business investment income in another state; royalty income earned on mineral assets owned in another state; income from property they rent or sold in another state; or because they worked in another state while maintaining full time residency in Colorado. Nonresidents are *not* able to claim the credit.

Resident taxpayers 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.

Technical Note

Colorado residents filing as individuals, fiduciaries, or estates are eligible for the credit.

Part-year residents are eligible for the credit for income they earned in another state while residing in Colorado. Income they earned while a resident of another state is not Colorado taxable income (i.e., if a taxpayer resides in one state and earns income and then moves to Colorado in that same year, the income they earned in the initial state is not taxable in Colorado).

Exhibit 1 shows an example of how the amount of the credit is calculated and applied against the taxpayer's income tax liability for a hypothetical taxpayer with a total of \$100,000 in taxable income, with \$90,000 earned in Colorado and \$10,000 earned in another state.

Exhibit 1

Calculation of the Credit for Taxes Paid to Other States

| | |
|--|--|
| 1. Income earned in Colorado and Other State is combined to calculate Total Taxable Income. | Total Taxable Income: \$100,000 |
| <p>A pie chart illustrating the composition of the total taxable income. The chart is divided into two segments: a large green segment representing Colorado Income at 90% (\$90,000) and a smaller blue segment representing Other State Income at 10% (\$10,000). Dotted lines connect these segments to the corresponding income breakdowns in the subsequent steps of the calculation.</p> | |
| 2. The Colorado Income Tax Rate is multiplied by Total Taxable Income to calculate Colorado Tax Liability. | Colorado Tax Liability: $4.4\% \times \\$100,000$ = \$4,400 |
| 3. Credit is calculated based on the proportion of income from the Other State x Colorado Tax Liability. | Credit Calculation: $10\% \times \\$4,400$ = \$440 |
| 4. Compare credit amount to the Actual Income Tax Paid to the Other State and claim the smaller amount. | <p>Taxpayer claims \$440 credit unless taxes paid to the other state are less* than \$440. Then taxpayer claims the actual amount paid.</p> <p><small>*Taxpayers will use the proportional calculation in states with a higher tax rate than Colorado's. In states with a lower tax rate than Colorado's, where final taxes paid to the other state are less than the proportional credit calculated, taxpayers will use their actual taxes paid.</small></p> |
| 5. Taxpayer reduces their Colorado Tax Liability by the credit. | $\\$4,400 - \\440 = \$3,690 |

Source: Section 39-22-108, C.R.S., and Office of the State Auditor analysis of the calculation of the credit.

We considered the purpose of the credit to be to prevent double taxation of income for Colorado residents who earn, and pay tax on, income from another state. Preventing double taxation of the same income across different states aligns with the U. S. Constitution (Article I, Section 8, Clause 3), which gives Congress the power to regulate interstate commerce and, therefore, prohibits states from enacting laws that would discriminate against interstate commerce.

Statute does not provide performance measures to evaluate whether this credit is meeting its purpose; therefore, we developed the following performance measures to evaluate the credit:

Technical Note

The dormant Commerce Clause refers to the prohibition, implicit in the Commerce Clause [Article I, Section 8, Clause 3 of the U.S. Constitution], against states passing legislation that discriminates against or excessively burdens interstate commerce.

In 2015, the U.S. Supreme Court ruled that certain tax provisions that effectively double tax income earned outside the state is unconstitutional as the double taxation results in unfavorable treatment of interstate commerce. [Comptroller of the Treasury v. Wynne].

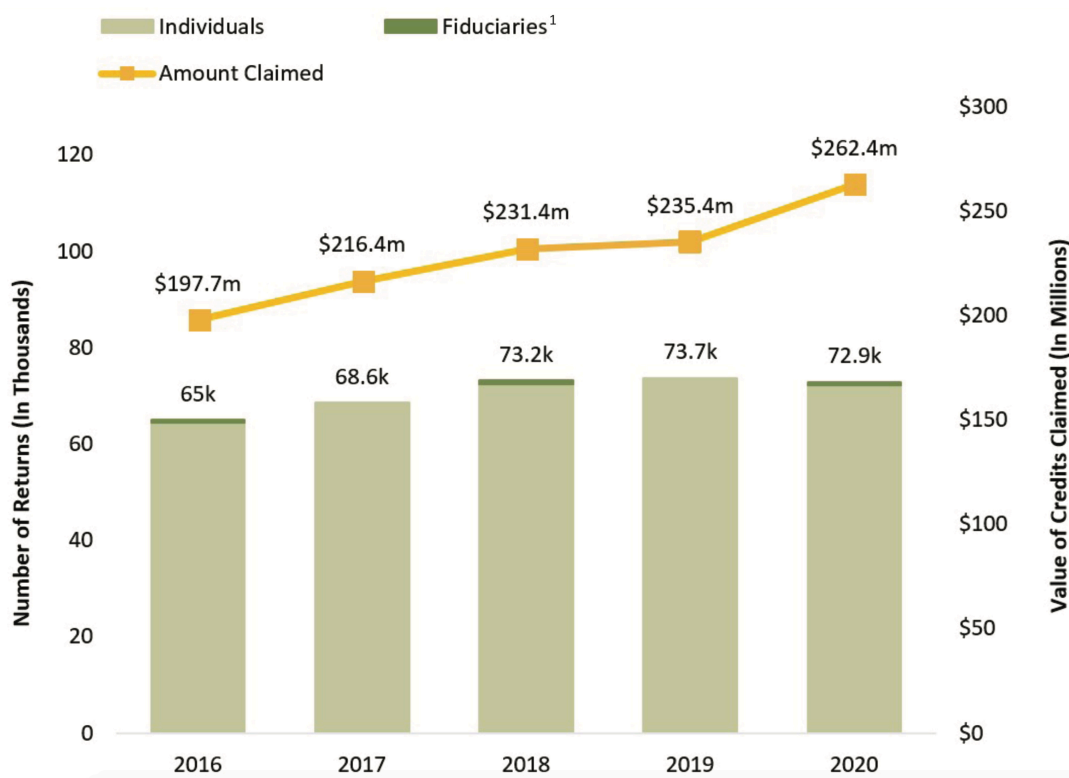
- To what extent is the credit being used?
- To what extent does the credit avoid double taxation of income for residents who earn income and pay taxes to other states?

Evaluation Results

The credit is likely meeting its purpose because it is extensively used and avoids double taxation on income earned in other states; however, it may not eliminate double taxation in some distinct situations.

In Tax Year 2020, the most recent year for which data is available, **about 72,900 individual and fiduciary Colorado taxpayer accounts claimed about \$262.6 million in credits.** Exhibit 2 shows the credit's use among individual and fiduciary taxpayers in the 5 most recent years for which data is available—with individuals comprising almost all of the claims.

Exhibit 2
Total Number of Returns Claiming the Credit and Total Credits Claimed
Tax Years 2016 through 2020



Source: Office of the State Auditor analysis of Department of Revenue individual taxpayer data for Tax Years 2016 through 2020.

¹Fiduciaries are not reported in the data for Tax Years 2017 and 2019.

While the total number of credit claimants is around 71,000 and the credit appears to be widely used, data is not available on the exact number of taxpayers eligible for the credit, and therefore we cannot determine what portion of eligible taxpayers use the credit.

We did find that the portion of Colorado taxpayers claiming the credit has stayed relatively consistent between 2015 and 2020, the most recent year of data available, ranging from 2.3 to 2.4 percent of returns filed. Additionally, for individuals, higher income taxpayers more frequently claim the credit than lower income taxpayers. For example, 36 percent of full-year resident taxpayers with federal Adjusted Gross Incomes (AGI) of \$1,000,000 or more claimed the credit, compared to only about 1 percent of full-year resident taxpayers with an AGI between \$10,000 and \$49,999. Exhibit 3 provides more information on usage of the credit among individual tax returns in Tax Year 2019.

Exhibit 3

Credit Usage as a Percentage of Total Individual Tax Returns Filed¹, by AGI, for Tax Year 2019

| Size of Federal AGI | Total Number of Returns Filed | Number of Returns Claimed Credit | Percentage of Returns Claimed Credit |
|--------------------------|-------------------------------|----------------------------------|--------------------------------------|
| \$ 10,000 to \$ 49,999 | 1,034,551 | 11,892 | 1% |
| \$ 50,000 to \$ 99,999 | 634,001 | 14,484 | 2% |
| \$ 100,000 to \$ 499,999 | 558,217 | 34,588 | 6% |
| \$ 500,000 to \$ 999,999 | 21,978 | 4,782 | 22% |
| \$ 1,000,000 and over | 10,294 | 3,707 | 36% |

Source: Office of the State Auditor analysis of Department of Revenue individual taxpayer data for Tax Year 2019.

¹ Department of Revenue Individual Statistics of Income data is for full-year residents only and does not include part-year residents or fiduciaries who may have filed returns or claimed the credit.

Further, it appears that eligible taxpayers are generally aware of the credit. 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. Additionally, the Department of Revenue (Department) announced a request for public input in April 2023 for rule revisions to improve clarity and provide additional guidance for calculating the credit and did not receive any comments regarding the operation of the credit, suggesting that stakeholders understand the eligibility requirements and the process to claim the credit. Also, for taxpayers who prepare their own taxes, Department forms, and third-party software accepted by the Department (e.g., TurboTax, TaxAct, H&R Block) provide clear notice of the availability of the credit and instructions for how to calculate and claim it. We also found that similar credits are available in every other state that levies a

tax on wage income, therefore tax preparers who work in other states besides Colorado and taxpayers who earn income outside of the state might already be familiar with similar credits in other states.

Although the credit generally avoids double taxation on income earned in another state, it may not eliminate double taxation in some distinct situations. Because of the way the credit is structured—accounting for income and taxes paid on that income in another state—the credit generally avoids a taxpayer having to pay state income tax to multiple states on the same income. Additionally, the structure of the credit prevents taxpayers from receiving a credit in excess of the taxes they actually paid to states with lower tax rates because the credit is the lesser of the actual tax paid, or a prorated share of their income from other states in comparison to total Colorado income. For example, as shown in Exhibit 1, if a state has a lower tax rate than Colorado, the taxpayer would only receive a credit for the amount of tax they paid on that income to the other state, and would still owe Colorado income taxes on the difference of what would have been owed if the income was only taxed in Colorado.

However, there are some types of income and circumstances when the credit would not apply, so double taxation would not be prevented. The credit is limited to income that is earned in a specific location (e.g., wages, rental income, royalties on oil and gas interests) and does not apply to income that is *not* earned in a specific location (e.g., dividends). Therefore, if a taxpayer meets residency qualifications in Colorado and another state, and is considered a resident of both states, they would owe taxes to both states on the non-location specific income. Additionally, the credit is only available for taxes paid in the same year. For example, if a taxpayer paid taxes in another state on retirement contributions, and later took retirement distributions while residing in Colorado, the taxpayer would not be able to apply a credit against their income taxes for the retirement distribution. We did not have data to determine how often these situations occur, but the Department reported that these scenarios are generally infrequent.

Policy Considerations

We did not identify any policy considerations for this credit.

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