State Income Tax Refund Deductions

Tax Expenditure Evaluation • February 2024 • 2024-TE4

OFFICE OF THE STATE AUDITOR
COLORADO

The State Income Tax Refund Deductions allow taxpayers—including individuals, estates, trusts, and corporations—to deduct state income tax refunds that are included in their federal taxable income when calculating their Colorado taxable income.

Taxpayers who itemize deductions on their federal income tax returns can deduct the amount they paid in state income taxes during the year. When they file their state income tax return, a taxpayer will receive a state income tax refund if they overpaid state taxes during the year. As a result, they will have paid less in state income taxes than what they reported on their federal return as a deduction and will have underpaid their federal income taxes. When this happens, taxpayers are required to include their state income tax refund as income on their federal tax return the following year. Since Colorado uses federal taxable income as the basis for Colorado taxable income, the purpose of the deductions is to avoid taxing the state refund by allowing taxpayers to deduct it on their state tax return.

We found the deductions are meeting their purpose because eligible taxpayers are aware of the deductions and are claiming them. We also found that changes to federal law have reduced the number of individual taxpayers who have claimed the State Income Tax Refund Deduction in recent years.

- Data from the Internal Revenue Service and Department of Revenue show that in Tax Year 2020 nearly all eligible individual taxpayers took the deduction.
- The Tax Cuts and Jobs Act decreased the number of individual taxpayers who itemized deductions on their federal return, which decreased the number of Colorado taxpayers who would need to claim the deduction. In the first year the Act went into effect the number of claims decreased by approximately 310,000 taxpayers with a revenue impact decrease of $23.5 million.

Policy Considerations

We did not identify any new policy considerations for the deduction.

	State Income Tax Refund Deduction: **Individuals**	State Income Tax Refund Deduction: **Estates and Trusts**	State Income Tax Refund Deduction: **C-corporations**
Tax Type:	**Income**	**Income**	**Income**
Expenditure Type:	**Deduction**	**Deduction**	**Deduction**
Statutory Citation:	**Sections 39-22-104(4)(e), C.R.S.**	**Sections 39-22-104(4)(e), C.R.S.**	**Section 39-22-304(3)(f), C.R.S.**
Year Enacted:	**1964**	**1964**	**1964**
Repeal/Expiration Date:	**None**	**None**	**None**
Revenue Impact:	**$4.7 million (2020)**	**Could Not Determine (2020)**	**Could Not Determine (2020)**
Purpose given in statute or enacting legislation? **No**			

State Income Tax Refund Deductions

Background

The State Income Tax Refund Deductions allow taxpayers—including individuals, estates, trusts, and corporations—to deduct state income tax refunds that are included in their federal taxable income when calculating their Colorado taxable income.

State tax refunds can be included in federal taxable income for a taxpayer under the following scenario:

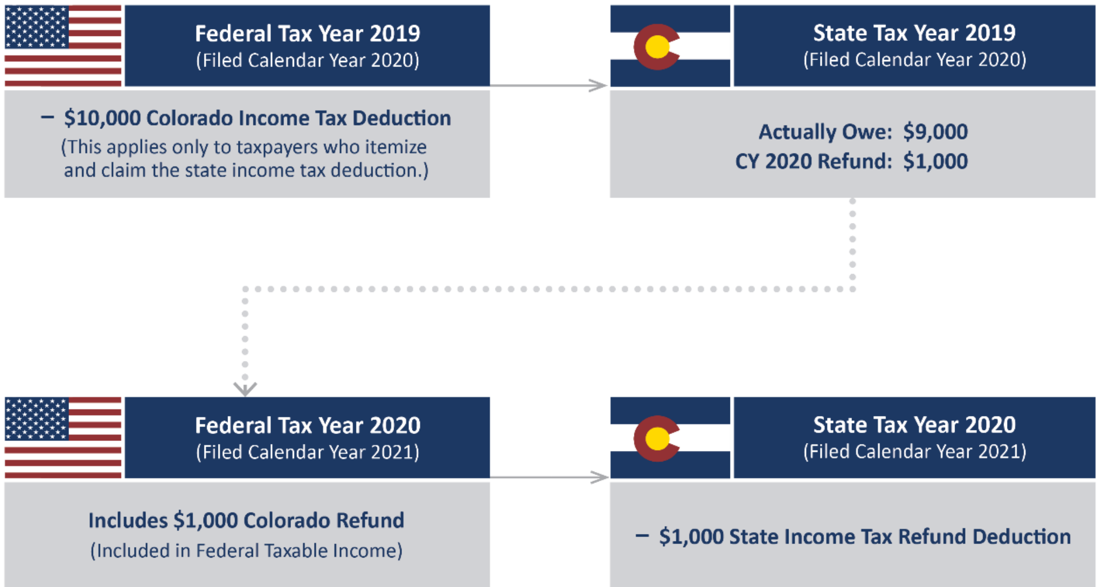
- First, the taxpayer chooses to itemize deductions instead of taking the standard deduction on their federal income tax return, and claims a federal deduction for state income taxes paid. Currently, individuals can deduct the amount they paid in state income taxes during the year up to $10,000.

- Second, the taxpayer files their state income tax return and receives a refund of all or a portion of the state taxes they paid, which occurs if they overpaid state taxes during the year.

- Third, because of the state tax refund the taxpayer will have paid less in state income taxes than what they reported on their federal return as a deduction, which effectively means they underpaid their federal income taxes. When this happens, taxpayers are required to report their state tax refund as federal taxable income on their federal tax return the following year to the extent that deducting it in the prior year decreased their federal taxable income to at or above what it would have been had the taxpayer claimed the standard deduction.

Since Colorado uses federal taxable income as the basis for calculating Colorado taxable income, the State Income Tax Refund Deductions are necessary to avoid applying state income tax to the refund the State provided the taxpayer in the prior year. Exhibit 1 demonstrates how the deductions are applied to prevent the prior year state tax refund from being taxed by the State.

Exhibit 1
How the Exemptions Prevent Additional Tax on State Income Tax Refunds



Source: Office of the State Auditor analysis of federal tax law [26 USC 61-63, 111, & 164] and state statutes [Sections 39-22-104(1.7)(b), (2), & (4)(e) and 304(1)(a) & (b) & (3)(f), C.R.S.]

In order to claim this deduction, individuals complete the Subtractions from Income Schedule form, noting the amount of the state income tax refund that was included in their federal income. Estates, trusts, and corporations put their state income tax refund on the line for "Other Subtractions." S-corporations have the option to file a composite return on behalf of their shareholders or pass the liability through to the shareholders, who report the income on their personal tax returns.

Of the 40 other states and the District of Columbia with a standard income tax, 38 have a similar tax expenditure that either excludes state income tax refunds from the calculation of state taxable income or allows a deduction similar to Colorado's.

These deductions were created in 1964 by the same legislation [House Bill 64-1003] that transitioned Colorado from calculating its own state income tax base to using the federal income tax base as the starting point for determining Colorado taxable income and they have remained largely unchanged since their creation. Based on our review of federal and state statutes, legislative history, Department of Revenue (Department) taxpayer guidance documents, and discussions with certified public accountants (CPAs), we inferred that **the purpose of these deductions is to prevent state income tax refunds for overpayments of tax from being taxed by the State the following year.**

Evaluation Results

We found that the deductions are meeting their purpose because eligible taxpayers are aware of them and claiming them. In order to determine the proportion of eligible taxpayers who are using these deductions, we examined the Internal Revenue Service's (IRS) Statistics of Income for individual taxpayers from Colorado, along with Department data, on the usage of the deductions for Tax Year 2020. The IRS Statistics of Income report estimates that about 114,000 Colorado taxpayers received a state income tax refund in Calendar Year 2020 for Tax Year 2019 and included it in their federal income for Tax Year 2020; these taxpayers should have generally been eligible for the State Income Tax Refund Deductions. In comparison, Department data showed about 114,000 individual taxpayers claimed the deductions in Tax Year 2020, indicating that nearly all eligible individual taxpayers are aware of the deduction and using it. Additionally, information on the deductions is widely available; information on the deductions is clearly provided on the Department's tax forms and instructions and by Turbo Tax, a tax return preparation software that is widely used; and CPAs we spoke with were also aware of it.

We lacked data for estates, trusts, and businesses to complete a similar analysis for those entities. To assess the awareness and use of these deductions among these entities, we surveyed CPAs from the Colorado Society of Certified Public Accountants for their feedback on the deductions. We received 8 responses from our survey, 7 of which indicated that CPAs as a whole are aware of these deductions and apply them to individual, estates/trusts, or corporations. These results are consistent with the feedback we received in our previous evaluation of the deductions. CPAs noted that corporations are unlikely to use the deduction as frequently as individuals because they often use accrual basis accounting and accrue the exact amount of taxes they owe on an ongoing basis. For corporations that use cash basis accounting, an overpayment and, thus, refund may occur, in which case CPAs report that these corporations will claim the deduction.

Department data indicate that the deduction had a revenue impact of $4.7 million for individual taxpayers in Tax Year 2020. Since the line of the tax return forms that estates, trusts, and C-corporations use to report the deduction is labeled "Other Subtractions" and is used to report multiple other deductions, it is not possible for us to determine the State Tax Refund Deductions' revenue impact for those types of taxpayers. The data provided by the Department show the total amount of all the subtractions taken on that line by estates and trusts totaled $6.9 million, and $44.4 million for corporations. However, based on the feedback we received from CPAs and an examination of the other deductions that are reported on this line, we believe that the State Tax Refund Deductions account for a small percentage of the deductions reported.

We also found that changes in federal law decreased the number of individual taxpayers who claim the State Income Tax Refund Deductions. Department data show that the use of the deduction by individuals decreased substantially from Tax Year 2018 to 2020, from 424,000 individuals claiming the deduction for a total of $28.2 million in Tax Year 2018 to 114,000 individuals claiming it for a total of $4.7 million in Tax Year 2020. This decrease appears to have been caused by the federal Tax Cuts and Jobs Act (TCJA), which significantly increased the federal standard deduction (from $6,500 to $12,000 for single filers and from $13,000 to $24,000 for joint filers to be adjusted annually) and placed a $10,000 cap on the total state and local taxes that can be deducted by individuals for Tax Years 2018 to 2025. As a result, it is likely fewer individual taxpayers itemized their deductions on their federal return, which is required in order for individual taxpayers to need to use the State Income Tax Refund Deduction.

Further, academic research indicated that the federal tax savings of the TCJA—which came from the increase in federal standard deductions and the elimination of federal personal exemptions—did not translate to lower Colorado income tax liabilities for taxpayers because it did not reduce their federal taxable income, which Colorado bases its income taxes on. Thus, some taxpayers ended up paying more state taxes and did not receive a state income tax refund, so had no need for these deductions. Since the increase of the federal standard deduction is set to expire after 2025, unless it is extended, it is likely that itemized filings at the federal level will return to levels seen prior to the implementation of the TCJA and the number of Coloradans claiming the State Income Tax Refund Deductions will increase as well.

Policy Consideration

We did not identify any new policy considerations for the deduction. Our previous evaluation suggested that the General Assembly review the State Income Tax Add-back Provision for Individuals, Estates, and Trusts for Tax Years 2018 to 2025 to clarify the order in which deducted state taxes are added back to Colorado taxable income. Since then, the Department has released guidance on its website indicating how a taxpayer is to calculate their addback amount, so we do not have any further policy considerations.

OFFICE OF THE STATE AUDITOR

State Auditor	**Kerri L. Hunter, CPA, CFE**
Deputy State Auditor	**Michelle Colin, JD**
Evaluation Managers	**Trey Standley, JD** **James Taurman, MPA**
Evaluation Supervisor	**Kim Tinnell, MBA, MS, MA**
Evaluation Team	**Amora Lenzi**

OFFICE OF THE STATE AUDITOR

C O L O R A D O

Working to improve government for the people of Colorado.