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Colorado Tax Law Update 2022

Colorado recently enacted 3 new tax laws containing multiple corporate and individual income tax changes.

1. H.B. 21-1311- Income Tax
2. H.B. 21-1327 – State & Local Tax Parity Act for Business
3. H.B. 20-1420 - Adjust Tax Expenditures For State Education Fund

Links to the actual bills can be found here, here & here.

The following 4-minute read summarizes in 2,500 words or so what is needed to bring a cloud over even the most fun gatherings of our Colorado neighbors and friends. My better half also quipped that proofing it for edits, errors and omissions cured her insomnia 3 times last night.

Bottom line, density alert, bravely forge ahead!

H.B. 21-1311- Income Tax - summary

In the legislative declaration of H.B. 21-1311, the legislature states that "the purposes of this act are: (I) [t]o conform Colorado's tax code with provisions commonly used in other states, so that Colorado is less of an outlier around the country in how taxpayers compute their taxes owed."

- **Colorado's Qualified Business Income Deduction**
    - As per CRS § 39-22-104(3)(o) the existing Colorado income cap for the allowance of the IRC Sec. 199A deduction for qualified business income (previously described in the PTE tax election section above) has been extended through tax years beginning before 2026.
    - Under existing law, this provision applied to tax years beginning in 2021 or 2022. An addition equal to the amount of the deduction is required for single filers with adjusted gross income over $500,000 and joint filers with adjusted gross income over $1 million.

- **Capping Itemized Deductions**
    - As per CRS § 39-22-104(3)(p) beginning in 2022, taxpayers with federal adjusted gross income of at least $400,000 must add back to Colorado

taxable income itemized deductions over a capped amount ($30,000 for single taxpayers, $60,000 for married filing jointly).

- **Capping Qualified Tuition Plan Contributions**
    - For tax years beginning in 2022, the deduction for contributions to Colorado IRC Sec. 529 qualified tuition plans, previously unlimited, has been capped at $20,000 per year, per beneficiary for single taxpayers, and $30,000 for joint returns.
    - As per CRS § 39-22-104(4)(i)(II) beginning in 2023, the allowable deduction will be adjusted annually based on the average change in the cost of attendance at a state higher education institution.
    - As per CRS § 39-22-104(4)(i)(V) an annual reporting requirement from the state's IRC Sec. 529 plan administrator to the Colorado Department of Revenue shall include contribution and distribution data for each account holder who is a Colorado taxpayer.
    - *Editorial Commentary*
        - The individual income tax return already requires that beneficiary social security numbers be reported to claim a subtraction for contributions to 529 accounts.
        - While convenient for the Department for audit purposes, the automatic reporting of account information to a government agency may prompt privacy concerns.
        - The state's newly adopted information reporting requirement for IRC Sec. 529 plan contributions and distributions appears to echo the obsolete remote seller sales and use tax reporting requirements.
            - In the case of the sales tax reporting requirement, the U.S. Supreme Court in *Direct Marketing Ass'n v. Brohl*, 575 U.S. 1 (2015) upheld the state's requirement that third parties provide the information required to trace uncollected sales and use tax.
        - The state appears to be preparing to pursue a similar disclosure effort on education savings accounts.

- **Increasing Earned Income Tax Credit**
    - As per CRS § 39-22-123.5(2), (2.5), (2.7) beginning in 2022, the amount of the state earned income tax credit has been increased to 20% of the federal credit.
    - As per CRS § 39-22-129(3.5) the state child tax credit also is expanded for tax years beginning in 2022 to include children without Social Security Numbers adjusting the child tax credit based on adjusted gross income as follows:

        - 30% for AGI under $25,000
        - 15% for AGI between $25,000 - $50,000
        - 5% for AGI between $50,000 - $75,000

- **Decoupling Meal expense from IRS**
    - Under the federal CARES Act a temporary increase in the deductibility of meals expenses from 50% to 100% as per IRC Sec. 274(n)(2)(D).
    - Beginning in 2022, any amount of meals expense in excess of 50% of the total expense must be added back to Colorado taxable income.

- **Corporate income tax - *Combined reporting changes***
    - States generally follow one of two rules to determine apportioned income for multistate corporations subject to combined reporting standards.
    - If a state mandates unitary combined reporting, related corporations that fall under the unitary reporting rules are subject to either the Joyce or Finnigan approach.
    - The Tax Foundation offers a good post on the difference.
        - "Science split the atom, and Joyce and Finnigan split the world of tax apportionment."
    - Under *Joyce*, nexus/connection to a given state is based on a separate company-by-company analysis, even when subject to combined reporting rules.
        - Historically, Colorado has followed the *Joyce* rule in determining income apportioned for combined groups.
    - Under *Finnigan*, if one member of a combined group has sufficient nexus in a particular state, then all members are subject to reporting and tax within the state.
        - **Under H.B. 21-1311, Colorado will follow the *Finnigan* rule for the 2022 tax year and thereafter as per CRS § 39-22-303(11)(c)(II)(B).**
    - Colorado follows a water's edge rule to determine the composition of a combined filing group.
        - Corporations with at least 80% of property or payroll outside the U.S. are excluded from the combined group as per CRS § 39-22-303(8)(a)
    - For tax years beginning in 2022, affiliated C corporations incorporated in foreign jurisdictions for the purpose of tax avoidance are also includible in the combined group as per CRS § 39-22-303(8)(b)(I).
    - All businesses that are federally defined as C corporations are subject to this rule, and if a business is included because of this provision, such business is considered to be a C corporation for all aspects of the Colorado corporation income tax as per CRS § 39-22-303(8)(b)(III).

- A C corporation is presumptively incorporated in a jurisdiction for the purpose of tax avoidance if it is incorporated in a tax haven jurisdiction.
    - The tax haven jurisdictions are listed in CRS § 39-22-303(12)(b)
- As per CRS § 39-22-303(8)(b)(II) a rebuttable presumption that a corporation incorporated in a tax haven country has a tax avoidance purpose, and the taxpayer must rebut the presumption by meeting federal economic substance standards described in IRC Sec. 7701(o).
    - The statute further provides guidance on how taxable income and apportionment should be determined for these foreign incorporated affiliates.
    - Any affiliate which is not included in a federal corporate income tax return must start with its audited book net income.
        - As per CRS § 39-22-304(1)(b)(I) this net income must then be adjusted according to U.S. generally accepted accounting principles, and then for any book/tax adjustments necessary under federal and Colorado rules.
        - As per CRS § 39-22-304(3)(j) & (q) the legislation also includes certain subtractions in arriving at Colorado taxable income that are related to the new foreign corporation tax avoidance provisions.

- **Other provisions**

    - Limiting the capital gains subtraction by redefining qualified Colorado taxpayer to mean someone who has no overdue state tax liability. Schedule F filers are excluded.
    - Extending the limit to 1/1/2026 on the federal deduction allowed under section 199A of the internal revenue code for taxpayers with adjusted gross income exceeding $500,000 ($1,000,000 for married/joint taxpayers) disallowing an enhanced (100%) federal deduction for food and beverage expenses at restaurants.
    - Allowing a subtraction from Colorado taxable income in amounts related to repealing the cap on the deduction for certain social security income.
    - Allowing a temporary income tax credit for a business equal to a percentage of the conversion costs to convert the business to a worker-owned coop, an employee stock ownership plan, or an employee ownership trust.
    - Modifying the computation of the corporate income tax receipts factor to make it more congruent with combined reporting.
    - Preventing corporations from using tax shelters in foreign jurisdictions for the purpose of tax avoidance.

- Clarifying that certain captive insurance companies are not exempt from income tax

- *Editorial Commentary*
  - The reference to the federal economic nexus standard in IRC § 7701(o) is interesting because states recently have been relatively silent on this provision. A state resurgence on this issue seems inevitable.
  - The interaction of the *Joyce* and *Finnigan* rules with the state's throwback provisions may significantly impact sellers of tangible personal property.
  - Under the *Finnigan* rule, sales to states where any member of the combined group has nexus are not subject to throwback.
  - The impact of the change is heavily fact-dependent and will require taxpayers to reassess existing positions taken in apportionment calculations.

H.B. 21-1327 – State & Local Tax Parity Act for Business - Pass Through Entity (PTE) tax election

In 2017, the Tax Cuts and Jobs Act (TCJA) placed a limit on the state and local tax (SALT) deduction on individual taxpayers of $10,000. This "SALT cap" impacts tax payers itemize their deductions on Schedule A.

In response states across the nation, including Colorado have enacted 'PTE taxes' as a reaction to the SALT deduction cap statutes memorialized in 26 U.S. Code § 164 - Taxes

Colorado has followed the trend of approximately 20 states in adopting a PTE tax election and providing a mechanism for owners to fully deduct state income tax expense on their federal returns.

The state has incorporated guidance for NOL carryovers and provides for a credit for taxes paid to other states.

Such provisions were not included in the first wave of SALT cap workarounds, making the election less advantageous in some states.

Colorado's recently enacted "SALT Parity Act" provides an elective PTE tax starting in 2022 as a means to provide a push back to the insanity of this euphemistically referenced 'Trump Tax'. Specifically:

- This new legislation amends CRS §§ 39-22-340 & 39-22-346 allowing partnerships and S corporations the opportunity to elect to pay Colorado

income taxes on behalf of the owners at the entity level as spelled out in CRS § 39-22-343.
- To achieve this, the S-corporation or partnership, aka pass through entity (PTE), **makes an annual election**, which is available beginning in 2022 and until the federal cap sunsets in 2025.
- As per CRS § 39-22-342(2) the election is binding upon all PTE owners.

Other Details

- An electing PTE is subject to tax at Colorado's flat 4.55% rate applied to a tax base comprised of the electing owners' distributive/pro rata share of Colorado-sourced income as well as the resident owners' distributive share of income attributed to other states.
- As per CRS §§ 39-22-344(3) & 39-22-346 - Any credits generated by the partnership are applied to the tax liability at the entity level, including a credit for taxes paid in other states.
- Net operating losses (NOLs) and excess income tax credits may be carried forward and applied at the entity level in a future year when the entity makes the election.

Editorial Commentary - Be Aware

- Colorado is one of only three states that currently allows certain taxpayers to take the IRC § 199A deduction for state income tax purposes
- However, making the 'SALT' election negates the Internal Revenue Code (IRC) Sec. 199A deduction for qualified business income available for Colorado purposes.
    - As per CRS §§ 39-22-344(3) & 39-22-346 - If an individual taxpayer benefits from the IRC Sec. 199A deduction, and that individual is a partner, shareholder or member in an electing PTE, the IRC Sec. 199A deduction must be added back on that individual's Colorado return as per CRS § 39-22-104(3)(r).

H.B. 20-1420 - Adjust Tax Expenditures for State Education Fund - Updated CARES Act conformity guidance

In July 2020, Colorado enacted H.B. 20-1420 in response to the CARES Act causing the Colorado Department of Revenue to update its guidance on state conformity to the federal provisions for corporate and individual income tax purposes.

- As per CRS § 39-22-103(5.3), the Department adopted a regulation in June 2020 to clarify that Colorado's statutory conformity to the IRC shall be applied on a prospective basis.
- This decoupled Colorado's corporate and individual income tax regimes from several major provisions of the CARES Act.

AS per H.B. 21-1002 in January 2021, Colorado enacted legislation to create a subtraction for certain deductions disallowed by the state.

- This legislation provides for a limited recapture of these disallowed deductions in tax years beginning in 2021 and thereafter.
- As explained by the Colorado Department of Revenue updated guidance, the allowable subtraction is an aggregate amount, calculated in multiple steps, based on the taxpayer's Colorado taxable income for each of the preceding tax years which were affected by the CARES Act.
- The subtraction is limited to tax years beginning in 2021, but excess subtraction amounts may be carried forward to subsequent tax years (though such carryforward is also subject to limitations).
- The guidance explains the computation of the subtraction and how various adjustments should be reported on the Colorado income tax returns.
- For further discussion of this legislation, see GT SALT Alert: Colorado creates CARES Act modifications.

The guidance also clarifies the state's treatment of PPP loans – which is HUGE.

- As per P.L. 116-260 the Consolidated Appropriations Act of 2021 expenses paid with proceeds from a forgiven PPP loan are deductible for federal income tax purposes enacted on December 27, 2020.
- As per CRS § 39-22-103(5.3) Colorado's IRC conformity regulation interprets the rolling conformity statute to be applicable on a prospective basis only, taxpayers may not deduct such expenses for tax years ending before December 27, 2020.

Editorial Commentary

The Department's guidance on CARES Act conformity provides welcome clarity on the computation of the subtraction to recapture certain disallowed federal deductions.

However, the Department's interpretation of the state's rolling conformity statute continues to add complexity as applied to the treatment of PPP loans.

Most states have conformed to federal PPP loan forgiveness and allow a deduction to taxpayers negatively impacted by the COVID-19 pandemic.

Colorado and Utah are among the few holdouts which have allowed unfavorable treatment under existing rules to stand.