COLORADO FISCAL POLICY INSTITUTE

Revenue Options: The Other Side of the Ledger

Colorado cannot simply cut its way back to prosperity. Instead, lawmakers should look to revenue options to help close the state's current budget gap. The Colorado Supreme Court (*Mesa County v State of Colorado*, 2009) opened the door for the Legislature to reconsider past tax policy decisions. All tax credits, exemptions, and means of sheltering income must be weighed against the harmful effects of budget cuts. Because Coloradans are faced with serious cuts to public services, COFPI believes that lawmakers should consider the options outlined below:

Suspend the Net Operating Loss Deduction*

Current law allows corporations to deduct losses incurred in previous years from their current year revenue to determine taxable income. Therefore, if a corporation is profitable in a year after a loss, they can use the loss from the prior year to offset income in the profitable year. Colorado could suspend the net operating loss deduction for the next two years as a way to generate income during this recession. California has adopted that approach in four of the past seven years (2002, 2003, 2008, & 2009). **COFPI estimates the State of Colorado could gain $34 million annually by suspending net operating loss deductions.**

Decouple from the Domestic Production Activities Deduction*

The domestic production activities deduction is a federal corporate tax deduction enacted in 2004 for manufacturers. This deduction is an additional tax break that effectively lowers the federal corporate tax rate for domestic manufacturers by 3%. There are currently 20 states that disallow this deduction. **COFPI estimates that if Colorado also disallowed this corporate deduction, the state could gain $23 million annually.**

Require Withholding for All Non-Resident Partners & Shareholders†

Colorado currently does not require withholding on non-resident individuals if the person signs an agreement to pay tax or is included in a composite return. By requiring partnerships and S-corporations to withhold tax on non-resident partners, the state would make non-residents with Colorado tax liability pay their fair share. **COFPI estimates the State of Colorado could gain $4 million in revenues annually by requiring withholding of income tax due by non-residents.**

Sales Tax Enforcement for Internet Sales†

Colorado currently charges a use tax on all sales, including internet sales. However, Colorado has no mechanism to collect out-of-state internet use tax. To boost collection, Colorado could follow the lead of New York and Rhode Island and compel large out-of-state internet retailers to collect a sales tax on behalf of customers. **COFPI estimates the State of Colorado could gain $6 million in new sales tax revenue annually by amending its tax statue as New York and Rhode Island have.**

Limit the Salary Deduction for Corporations and Pass-through Entities*

Current law allows corporations to deduct salary expenses from revenue when calculating taxable income. Colorado could potentially limit the deduction allowed for salary expense per employee. The federal deduction is limited to $1 million for a firm's top-paid four executives but has no limit for all other salary expenses. If Colorado limited the salary deduction to $250,000 per employee, **COFPI estimates the state could derive as much as $175 million in new revenue annually**.

Make the Enterprise Zone Credit More Targeted and Accountable

In 2008, Colorado distributed $47 million in tax expenditures related to Colorado enterprise zone credits. This credit was created in 1986 by the Colorado General Assembly to help economically blighted areas of the state. However, the economically blighted areas of Colorado, or "enterprise zones," cover more than 70% of Colorado's land mass. Reports by Colorado Legislative Council and the State Auditor were unable to conclude whether or not the enterprise zone program has been effective. A study by the University of Colorado concluded that if enterprise zones were shown to have any impact on employment, the results show that they had a negative impact on employers with over fifty employees. Also there was no evidence that the program had any effect on smaller establishments. The Enterprise Zone Credit should be better targeted and include greater accountability measures.

Closing Tax Exemptions and Credits

Each of the various tax exemptions and credits that exist must be critically examined to ensure that they are an efficient use of taxpayer money. The benefits of these exemptions and credits must be weighed against the impact of impending budget cuts. Some of these provisions are decades old and have no place in a 21st century economy.

Conclusion

Colorado faces a perpetual budget crisis, because we do not have a revenue system that sustains the public services Coloradans rely on every day. These revenue options will help close Colorado's current budget gap. In the longer term, unless **decision makers address the state's tax system in a comprehensive way and work to modernize its broken fiscal system, Colorado will continue to face perpetual budget problems to the detriment of our economic future.**

Tax Change Timing Restrictions

Under Article 10 section 20 (8) of TABOR tax rate increases and redefinitions of taxable income are only applicable starting the calendar (tax) year following enactment. Thus revenue options involving income redefinitions or tax rate changes experience a calendar year lag. For instance, any such change enacted before the end of calendar year (CY) 2009 would then be applicable only in CY 2010—the second half of fiscal year (FY) 2010 and the first half of FY2011.

**Revenue options marked with a "*" fall under the above TABOR timing restriction and suffer from a calendar year lag.*
† Revenue options marked with a "†" do not fall under the TABOR timing restriction and offer immediately realizable revenue gains to the state. Options so labeled would have immediate effect, either producing an immediate continuous stream of revenue (in the case of an internet nexus redefinition) or immediate eligibility for collection within the calendar (tax) year of passage (in the case of non-resident withholding requirements).

Estimated Revenue Gains (Millions of Dollars)

Measure	2010	2011	2012
Salary Deduction Cap*	$169	$175	$184
Net Operating Loss Suspension*	$34	$34	$40
DPAD Decoupling*	$19	$23	$27
Internet Retail Sales Tax Enforcement†	$5.6	$5.8	$6.1
Non-Resident Withholding†	$4.2	$4.3	$4.5
TOTAL	$232	$242	$262

For more information, please contact Carol Hedges at 303-573-5669 x309 or chedges@cclponline.org.