



Limitation on deduction of business expenses

With revenue deficits at an all-time high, Colorado taxpayers should not be required to subsidize excessive salaries for corporate employees. House Bill 1263, sponsored by Rep. Jack Pommer and Sen. Betty Boyd, addresses this inequity.

Federal law allows corporations to deduct remuneration paid to employees as a business expense. For tax purposes, remuneration includes wages, salaries, or other compensation, such as vacation allowances, bonuses, commissions and fringe benefits. As a result, salary and bonus expenses reduce the amount of federal taxes paid by corporations.

Colorado starts its calculation of taxes owed to the state with the amount calculated for federal taxable income – an amount that has been reduced by the salary and bonus deduction. As a result, corporate taxes paid in Colorado are reduced because of the federal deduction.

In tough economic times like these, it is hard to justify cutting spending on critical services so corporations can reduce their state tax bill. Colorado could limit the deductibility of salaries and bonuses to \$250,000 per employee and increase state revenue by approximately \$21.5 million annually.

Currently, the federal government recognizes some limitations on the deductibility of salaries and bonuses by capping the deduction at \$1 million for the top four executives in each corporation. Colorado could choose to limit excessive compensation even more. States such as Texas have chosen to create their own, lower excessive compensation cap. The Texas Margin Tax disallows any business expense deduction for any compensation paid to an officer, director or employee in excess of \$300,000.

It is important to note that corporations, not their employees, are the beneficiaries of the salary deduction and it is the corporations that would be liable for the additional taxes. The adjustment would not limit the compensation corporations may pay employees; it would merely disallow any excessive compensation (anything over \$250,000) from being deducted as a business expense. The adjustment would apply only to the amount in excess of \$250,000. (For example, if an employee is compensated at \$300,000 per year, the corporation will be allowed to deduct \$250,000 of that employee's compensation and will only pay tax on the remaining \$50,000.)

Estimated combined increase in revenue: At least \$25.1 million

Example:

What follows is an illustration of the limitation. For purposes of the example, assume that the fictional company "X Co." has \$3.8 million in gross receipts and takes a \$380,000 deduction for salaries and wages. X Co. has federal taxable income of \$228,000 and apportions 5 percent of sales to Colorado.

The Colorado corporate income tax form begins with federal taxable income as reported in the federal return. With the business expense limitation in place, X Co. will add the compensation deduction taken at the federal level to its federal taxable income on the Colorado return. Once the “add back” has been made, X Co. will then be permitted to “re-deduct” any compensation below the excessive compensation limit (\$250,000), leaving only the excessive compensation, no longer deductible from taxable income. In this example, X Co. makes 5 percent of its total sales in Colorado. Therefore, according to current Colorado tax law, only 5 percent of its total federal taxable income is taxed here.

In the example, the addition of the business expense limitation results in roughly a \$44 increase in Colorado tax owed. This is an 8 percent increase in tax liability for X Co.

X CO. EXAMPLE		
Gross receipts	\$3,800,000	
Compensation	\$380,000	
Federal taxable income	\$228,000	
	Without business expense limitation	With business expense limitation
COLORADO RETURN		
Federal taxable income	\$228,000	\$228,000
Plus compensation deducted at federal level	N/A	\$380,000
Less compensation below excessive compensation cap	N/A	\$361,000
Colorado taxable income	\$228,000	\$247,000
Colorado sales apportionment (5 percent)	\$11,400	\$12,350
Colorado tax owed (at 4.63 percent)	\$528	\$572
Additional state revenue	\$44	
Percent increase in corporation’s state tax liability	8 percent	

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