PRE-1987 NET OPERATING LOSS DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION SUMMARY

APRIL 2019
2019-TE10

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1964
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it cannot be used

WHAT DOES THIS TAX EXPENDITURE DO?

The Pre-1987 Net Operating Loss Deduction for Individuals, Estates, and Trusts (Pre-1987 Net Operating Loss Deduction) allows individuals, estates, and trusts to deduct Colorado net operating losses carried forward from a tax year beginning prior to January 1, 1987, when computing their Colorado taxable income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Pre-1987 Net Operating Loss Deduction. We inferred that the purpose is to allow individuals, estates, and trusts to carry forward and receive a deduction for Colorado net operating losses that were incurred in a tax year beginning prior to January 1, 1987, when Colorado transitioned from using a separate calculation for the net operating loss deduction to allowing the federal net operating loss deduction (i.e., a separate state calculation was no longer necessary).

WHAT DID THE EVALUATION FIND?

Our evaluation found that the Pre-1987 Net Operating Loss Deduction cannot be used and is, thus, no longer meeting its purpose.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing this tax expenditure.

PRE-1987 NET OPERATING LOSS DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Pre-1987 Net Operating Loss Deduction for Individuals, Estates, and Trusts [Section 39-22-104(4)(d), C.R.S.] (Pre-1987 Net Operating Loss Deduction) allows individuals, estates, and trusts to deduct Colorado net operating losses carried forward from tax years beginning prior to January 1, 1987 when computing their Colorado taxable income.

A net operating loss occurs when a taxpayer's allowable deductions exceed their income for the tax year. In general, a net operating loss means that a taxpayer has "negative income" in a particular tax year and therefore, does not have income tax liability in that year. Typically, net operating losses occur in a business context, such as when expenses exceed revenues for a tax year. Individuals, estates, and trusts may deduct a net operating loss on their federal tax return if they have a net operating loss from a business that is organized as a "pass-through entity," such as partnerships, S-corporations, and some limited liability companies. Pass-through entities are generally not subject to tax at the entity level, but instead, income and losses are passed on to the owners for tax purposes. In addition to net operating losses generated through business activities, there are limited nonbusiness instances in which an individual, estate, or trust can generate a net operating loss, common examples being net operating losses generated by deductions for casualty, disaster, and theft losses that exceed taxable income.

A net operating loss deduction carryforward allows a taxpayer to deduct a net operating loss in a future tax year to offset taxable income. This can ultimately reduce the taxpayer's tax liability across multiple future years.

House Bill 64-1003 created the Pre-1987 Net Operating Loss Deduction, which became effective January 1, 1965. At that time, Colorado began using federal adjusted gross income as the starting point for calculating Colorado adjusted gross income for individuals and federal taxable income as the starting point for estates and trusts. Although the federal tax code also provided for similar net operating loss deductions, there were likely differences between the state and federal provisions in how such losses were calculated and applied. The General Assembly created the Pre-1987 Net Operating Loss Deduction to maintain separate treatment of these deductions for state tax purposes. Specifically, the bill required taxpayers to add back the federal net operating loss deduction to federal adjusted gross income for state tax purposes and then subtract the Pre-1987 Net Operating Loss Deduction amount, when calculating Colorado taxable income.

In 1987, as part of a substantial revision and reenactment of the income tax section in the Colorado Revised Statutes, the General Assembly enacted House Bill 87-1331, which allowed individual, estate, and trust taxpayers to take the federal net operating loss deduction for tax years beginning after January 1, 1987. Thus, for Tax Years 1987 and beyond, there was no longer a need for the Pre-1987 Net Operating Loss Deduction. However, because some taxpayers had Colorado net operating loss deduction carryforwards remaining from tax years beginning prior to 1987, the deduction was still necessary to ensure that these taxpayers could apply them to future years for state tax purposes. Accordingly, House Bill 87-1331 amended the deduction and other net operating loss provisions in statute [Section 39-22-104(3)(a) and (4)(d), C.R.S.] so that only Colorado net operating loss deductions carried over from tax years beginning prior to January 1, 1987, qualify for the deduction. The Pre-1987 Net Operating Loss Deduction has remained unchanged since 1987.

Individuals claim the deduction on Line 17 ("Other Subtractions from Federal Taxable Income") of the Department of Revenue's Subtractions from Income Schedule (Form DR 0104AD). Estates and trusts claim this deduction on Line 5 ("Subtractions from Federal Taxable Income") of the Colorado Fiduciary Income Tax Return (Form DR 0105).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Pre-1987 Net Operating Loss Deduction. Based on the language in statute [Section 39-22-104(4)(d), C.R.S.], we inferred that the intended beneficiaries of the tax expenditure are individuals, estates, and trusts that have Colorado net operating losses carried forward from a taxable year beginning prior to January 1, 1987.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not directly state a purpose for this tax expenditure. Based on the language in statute, state and federal legislative history, and Department of Revenue guidance documents, we inferred that the purpose is to allow individuals, estates, and trusts to carry forward and receive a deduction for Colorado net operating losses that were incurred in tax years beginning prior to January 1, 1987, when Colorado transitioned from using a separate calculation for the net operating loss deduction to allowing the federal net operating loss deduction (i.e., a separate state calculation was no longer necessary).

WHAT PERFORMANCE MEASURES WERE USED TO EVALUATE THE TAX EXPENDITURE AND IS IT MEETING ITS PURPOSE?

Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are Colorado individuals, estates, and trusts using the Pre-1987 Net Operating Loss Deduction to apply net operating loss carryforwards from tax years beginning prior to January 1, 1987?*

RESULT: Because taxpayers could only carry forward applicable net operating losses for 15 tax years, taxpayers can no longer claim the deduction. Specifically, statute [Section 39-22-504(2)(a), C.R.S.] provides that the Pre-1987 Net Operating Loss Deduction allows net operating losses to be carried forward for the same number of years as the federal net operating loss deduction is allowed under the Internal Revenue Code, which is 15 tax years for net operating losses incurred in tax years beginning prior to January 1, 1987. Because the deduction only applies to net operating losses incurred in tax years beginning prior to January 1, 1987, the latest year that a net operating loss could have been generated in order to fall under the deduction was 1987, and it could have been carried forward until 2002. This is because a fiscal year taxpayer may have had a tax year that began prior to January 1, 1987, but ended in 1987. Therefore, taxpayers have not been allowed to use the Pre-1987 Net Operating Loss Deduction for 17 years, although we lacked data from the Department of Revenue to confirm that no taxpayers have used it more recently.

Therefore, we determined that the Pre-1987 Net Operating Loss Deduction is no longer meeting its purpose because taxpayers have not been able to use it since 2002.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

We did not identify any economic costs or benefits of the Pre-1987 Net Operating Loss Deduction since it can no longer be used.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Pre-1987 Net Operating Loss Deduction were eliminated, there would be no impact on the intended beneficiaries.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

This tax expenditure addressed an issue that occurred specifically between the Colorado and federal tax systems. Therefore, we did not conduct an analysis of similar tax expenditures in other states since this tax expenditure was specific to Colorado.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

Colorado currently allows the federal net operating loss deduction for individuals, estates, and trusts. This deduction is included in federal taxable income, and since federal taxable income is the starting point for calculating Colorado taxable income, no separate state calculation is necessary for individuals, estates, and trusts to take it.

Colorado also has a net operating loss deduction for corporations [Section 39-22-304(3)(g), C.R.S.] that requires state adjustments and is still commonly used by taxpayers. However, because it only applies to corporations, taxpayers who would be eligible for the Pre-1987 Net Operating Loss Deduction would not be able to claim it. We will be evaluating the Colorado net operating loss deduction for corporations in 2019.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

The Department of Revenue was not able to provide us with data to confirm that the Pre-1987 Net Operating Loss Deduction is no longer being used. Individuals would have claimed the deduction on Line 17 ("Other Subtractions from Federal Taxable Income") of the Subtractions from Income Schedule (Form DR 0104AD) and estates and trusts would have claimed it on Line 5 ("Subtractions from Federal Taxable Income") of the Colorado Fiduciary Income Tax Return (Form DR 0105). However, taxpayers aggregate several deductions on both of these lines and therefore, the Department of Revenue cannot provide information specific to the deduction.

To confirm that the Pre-1987 Net Operating Loss Deduction is not being used, the Department of Revenue would have to create new reporting lines on Forms DR 0104AD and DR 0105 and then capture and house the data collected on those lines in GenTax, the Department of Revenue's tax processing system (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2018 Tax Expenditures Compilations Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Since taxpayers can no longer claim this deduction, it would not be practical to amend the DR 0112.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the Pre-1987 Net Operating Loss Deduction since it does not have current or future applicability.