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Colorado Income Tax Act of 1964

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COLORADO INCOME TAX ACT OF 1964

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I. SCOPE

On March 24, 1964, the Governor approved the Colorado Income Tax Act of 1964.[1] Why was this 61-page statute necessary, how did it come into being, what is its effect, what does it mean? These questions, among many others, will be asked by the members of the Colorado Department of Revenue as they prepare the new regulations[2] and as they administratively resolve issues in the examination of returns; by taxpayers as they prepare returns; by tax advisors as they assist their clients; and by the courts as they resolve disputes between the state and the taxpayer. This article is written with the hope that the nature of the statute will be better understood so that its interpretation by the public and its advisors, the administrators, and the courts will not lose sight of its reason for existence. The writer has attempted to limit this article to substantive matters which would be of general interest to most practitioners and accordingly has not discussed provisions of the Act relating to non-residents, part-year residents, banks, regulated investment

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[1] Colo. Sess. Laws 1964, ch. 95, § 1. Throughout the remainder of this article reference to the Colorado Income Tax Act of 1964 will be made to "Act, § ....."

[2] The Colorado Department of Revenue released a 156 page draft of proposed regulations during the fall of 1964. The eagerness to explain the new law is accentuated by the fact that regulations explaining the former law were last published in 1951. The draft of the proposed regulations is hereafter called the proposed regulations although the draft has not yet been formally proposed and will probably be changed before the regulations are proposed or finalized. The author wishes to emphasize that the conclusions contained herein do not necessarily represent the thinking of the Colorado Department of Revenue.

companies, real estate investment trusts, and most procedural rules. Suffice it to say that changes in these avoided areas were drafted consistent with the basic objectives and principles as discussed below.

II. BACKGROUND

The federal income tax law that we now know originated in 1913. In 1937, almost a quarter of a century later, our legislature enacted the first Colorado income tax law in a form which was substantially similar to the then existing federal law. The ensuing quarter of a century saw numerous changes in the federal law, some of which were, after a period of time, adopted as part of our local law, but many of which were never so incorporated. Congress continued to amend and our General Assembly continued to try to catch up. With the wholesale revision of the federal laws in the 1954 Internal Revenue Code[3] it became evident that this race was never to be won.

At that point it became obvious that if we continued to have a federal income tax law and a completely distinct Colorado law we would be dealing with two independent sets of complicated rules and two independent sets of interpretations, regulations, and court rulings. It cannot be denied that the federal laws have always been complicated.

A second equally complicated set of local rules is unduly burdensome[4] if the local legislature can retain the power, by local statute, to determine local revenue and to vary from the federal rules when mandatory.

Accordingly, the General Assembly in 1955 directed the Legislative Council to analyze the feasibility of relating state income tax laws and returns to the federal laws and returns.[5] In 1960, a study[6] of the Denver Chamber of Commerce renewed the momentum of a federal tie-in which had been temporarily halted by the 1959 Report of the Governor's Tax Study Group.[7] The Chamber's study provided the impetus for a joint effort by the Colorado Bar Association and

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[3] For a list of some differences between federal law and the former Colorado law see, Lentz, *Pitfalls: Conflicting Requirements of the U.S. and Colorado Tax Statutes*, UNIVERSITY OF DENVER 6TH INST. ON FED. TAX 21 (1956); Hein, *Summary of Differences Between Federal and Colorado Income Taxes*, 28 COLO. CPA REPORT 3 (1963); 1 CCH COLO. TAX RPTR. 1073 (1964).

[4] *But See*, FINANCING GOVERNMENT IN COLORADO, REPORT OF THE GOVERNOR'S TAX STUDY GROUP 318-320 (1959).

[5] H.J. Res. 20, Colo. Sess. Laws 1955, at 960.

[6] Denver Chamber of Commerce, Colorado's Problems, Its Taxes . . . Its Future, at 20-26 (1960).

[7] *Supra* note 4.

the Colorado Society of Certified Public Accountants which finally persuaded the General Assembly in 1962 to submit a constitutional amendment to the electorate to permit our local statutes to be tied to federal laws.[8]

Immediately after approval[9] of the amendment in the fall of 1962, a special drafting committee, consisting of approximately thirty-five tax practitioners representing the Colorado Bar Association, the Colorado Society of Certified Public Accountants, the Trust Departments of the Denver Clearing House Association, and the Public Accountants Society of Colorado, was formed to draft a suggested statute which would implement the constitutional amendment. The committee analyzed the responses of all state departments of revenue which had already passed such conforming statutes. It weighed the suggestions for improvement contained in these responses. The committee determined to use the New York statute[10] as a guide for the taxation of individuals, partnerships, trusts, and estates and the Iowa statute for the taxation of corporations.

The entire committee was divided into five sub-groups — individual, partners and partnerships, trusts and estates, corporations, and special taxpayers (*i.e.*, banks, savings and loan associations, insurance companies, regulated investment trusts, real estate investment associations). Their charge was to determine the problems of conformity in their particular area and to propose appropriate language which would adopt the federal law as simply as possible while making provision for those minimum differences which were thought necessary for constitutional, transition from old law to new law, or limited practical reasons. The groups were told to keep the revenues as constant as possible but at the same time to discard the different Colorado treatment for accounting methods, accounting periods, definitions of inclusions, exclusions, and deductions. The sub-groups were to make no changes in the procedural law except

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[8] "The general assembly may by law define the income upon which income taxes may be levied under section 17 of this article by reference to provisions of the laws of the United States in effect from time to time, whether retrospective or prospective in their operation, and shall in any such law provide the dollar amount of personal exemptions to be allowed to the taxpayer as a deduction. The general assembly may in any such law provide for other exceptions or modifications to any of such provisions of the laws of the United States and for retrospective exceptions or modifications to those provisions which are retrospective." COLO. CONST. art. X, § 19, as submitted in S. Con. Res. 2, Colo. Sess. Laws 1962, at 312.

[9] SECRETARY OF STATE, ABSTRACT OF VOTES CAST 28 (1962). The vote was 231,784 for and 201,795 against.

[10] See Franken, Miller, Petite, Shapiro, *Simplification of Income Tax Returns for New York State Taxpayers — Report to Senate Committee on Finance and Assembly Committee on Ways and Means*, 15 TAX L. REV. 367 (1960).

to the extent that new concepts had to be incorporated into the procedural sections.

The sub-groups reported their conclusions to the chairman of the drafting committee who then met with the sub-chairmen of these sub-groups to analyze all reports. The suggested changes were circularized and the chairman redrafted the work product of the sub-groups to make sure that the various reports and suggested revisions meshed with one another.

The redrafted work product was again circularized to the sub-chairmen, and after necessary polishing and refinishing a proposed draft was submitted to the committee of the whole which studied the bill, made its suggestions, and again repolished and refinished the language. The draft was then submitted to the council of the section of taxation for its review, comments, suggestions, and criticism. The proposed draft was repolished and revised a fourth time.

By March of 1963 the tax technicians were satisfied with their proposed draft. At that time a series of meetings was held with representatives of the Colorado Department of Revenue to get their suggestions, criticisms, and comments. I doubt if so many taxpayers' advisors and the Colorado Department of Revenue have ever in the past worked so closely and so harmoniously with each other. The results of these meetings were incorporated in the proposed statute.

On May 3, 1963, a special joint legislative interim sub-committee consisting of representatives of the House Ways and Means Committee and the Senate Finance Committee met with representatives of the drafting committee and the Department of Revenue. The proposed draft of the statute was explained and discussed. The special legislative sub-committee appointed Senator Ranger Rogers, Representatives William Griffith and Robert Eberhardt, and James Wilson of the Legislative Reference Office to work with the drafting committee and the Department of Revenue to finalize the draft and determine revenue impact of the proposed changes.

The draft was finalized and was then approved and endorsed by the Colorado Bar Association, the Colorado Society of Certified Public Accountants, and the Public Accountants Society of Colorado. That final draft was presented to the Joint Legislative Interim Study Committee which, in September of 1963, approved the proposed bill. At that point the attorneys, accountants, and trust officers requested Governor Love to call a special session of the legislature to consider the bill prior to the end of 1963. For various reasons it was determined not to call a special session but instead to consider this matter in the 1964 "short session."

House Bill No. 1003 was introduced in the House; amendments were strenuously debated and passed under the leadership of Representative William Griffith. Further changes were made in the Senate where the bill was carried by Senator Ranger Rogers. A Conference Committee resolved the differences between the two Houses. The Act, which is a product of said legislative compromise, is explained in the following sections.

III. EXPLANATION OF THE ACT

A. RESIDENT INDIVIDUALS AND ACCOUNTING RULES

1. Rates.

The rates for individuals, estates, and trusts are the same as they were under the former law. Rates vary from 3 to 8 per cent of the "Colorado taxable income."[11] A credit equal to ½ of 1 per cent continues to be allowed for so much of the "Colorado taxable income" as does not exceed $9,000.[12] The credit reduces the tax by as much as $5 in the lowest bracket and as much as $45 in the top bracket. The net effect of the credit is to change the 3 to 8 per cent structure to 2½ to 8 per cent.

2. Surtax.

The additional 2 per cent surtax continues to be applied to Colorado resident individuals whose "Colorado gross income" consists of more than $5,000 of dividends, interest, and certain related intangible income.[13] Colorado gross income is specifically defined to mean federal gross income with certain modifications.[14] Therefore, since $100 of dividends is excluded from federal gross income, if a husband and wife jointly own stock, no surtax will be due on the first $10,200 of dividends and the 2 per cent surtax will apply on any excess. If a husband and wife jointly own a bank savings account, no surtax will be due on the first $10,000 of interest and the 2 per cent surtax will apply to any excess.

This writer submits that the surtax is a discriminatory tax and should be abolished especially since its revenue impact is negligible.[15] It discriminates against residents in favor of non-residents, against holders of stock and interest-paying securities or accounts in favor of holders of other types of investments such as rented

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[11] Act, § 4(2).
[12] Act, § 4(3).
[13] Act, § 6(1).
[14] Act, § 2(12).
[15] The Department of Revenue stopped tabulating these revenues when the exclusion was raised from $600.00 to $5,000.00. See Colo. Sess. Laws 1959, ch. 254 at 781.

property, against individuals who either are not in the business of receiving dividends and interest or are in such business as sole proprietors in favor of those who receive their dividends or interest through partnerships, trusts, or estates.[16]

The proponents of the new statute had more urgent problems to contend with than those which would be created had they attempted to defend the repeal of the surtax. Accordingly, they adopted the existing statute verbatim except where it was necessary to adopt new concepts such as "Colorado gross income" and "Colorado net income." We strove to keep Colorado revenues from this "discriminatory" tax constant — neither substantially increasing nor decreasing such revenues. Accordingly, it seems clear that the undistributed taxable income of Subchapter S shareholders (which is not treated as a dividend for federal purposes) should not be construed a quasi-dividend subject to the surtax.

3. *Measure.*

> Federal income taxes are computed by applying the following procedures:
>
> *Step 1. Determine the measure to which the rates are applied.* Gross income minus trade and business deductions[17] equals federal adjusted gross income which minus personal deductions (either standard or itemized) and minus personal exemptions equals the federal taxable income.
>
> *Step 2. Apply the rates to the measure which equals the tax liability before credits.*
>
> *Step 3. Subtract credits from the tax liability which will equal the amount of federal tax to be paid.*

It is apparent that the taxpayers' federal income tax bill is the end result of the inter-relationship of the tax measure, the tax rates, and the tax credits. How could the statute best tie the Colorado tax law to the federal law? Two alternatives are evident.

First, the statute could dictate that the Colorado income tax would be some percentage of the federal income tax, either before or after credits. Second, it could provide that the Colorado measure would be the federal measure and then apply Colorado rates and Colorado credits.

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[16] The dividends and interest of a sole proprietor are not reduced for this purpose by expenses incurred in generating that income whereas expenses of a partnership, trust or estate do offset the same type of income.

[17] The term "trade and business deductions" refers to all deductions allowed by INT. REV. CODE OF 1954, § 62.

The second alternative[18] was chosen for the following reasons:

(a) *State Autonomy.* State finances would be too dependent on federal law if the Colorado rate were tied to the federal rate. If Congress cut taxes substantially, as in 1964 and 1965, state revenues would be seriously jeopardized. Similarly, state taxes would go up substantially if federal taxes were raised either by broadening the federal base or increasing the federal rates. Further, Colorado legislators might believe that due to special Colorado agricultural, industrial, political, or economic conditions, specific federal rules should not be applied in our Colorado law. For example, Colorado is interested in assisting the infant oil shale industry. Federal law permits oil shale to be depleted at the rate of only 15 per cent. As we shall see, the legislature desired to grant an incentive to such industry by increasing the depletion rate to that accorded oil wells, *i.e.*, 27½ per cent. It could not have done so if we tied our tax rate to the federal rate. By using the second alternative, our state legislators retain the ultimate power to provide for different tax consequences whenever such differences are deemed imperative.

(b) *Constitutional Reasons.* It is generally believed that Colorado cannot constitutionally tax interest on federal bonds.[19] Also, because of transitional problems, an item may be taxed for federal purposes at some point in time after Colorado has already taxed it. If the statute simply tied rate to rate, Colorado would thereby tax income unconstitutionally whenever a taxpayer had federal income consisting of federal bond interest or income which had already been taxed by Colorado. Further, the constitutional amendment itself provided that the legislature would determine the value of the dependent deduction.[20] This mandate could not be accomplished if the Colorado rate were tied to the federal rate.

4. Colorado Adjusted Gross Income.

How does the statute implement the decision to tie the Colorado measure to the federal measure? The law provides that the first significant figure on the Colorado income tax return is the taxpayer's adjusted gross income from his federal return.[21] It is necessary to start with adjusted gross income instead of taxable in-

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[18] Because the Act ties measure to measure and not rate to rate, Colorado has no special rules regarding personal holding company taxes, accumulated earnings taxes, and denial of surtax exemptions to controlled corporations.

[19] See Colo. Reg. § 4(b) (1951); Macallen Company v. Massachusetts, 279 U.S. 620 (1929); 31 U.S.C.A. § 742; Annot., 100 L. Ed. 637 (1956); Annot., 99 L. Ed. 961 (1955); Annot., 94 L. Ed. 449 (1950).

[20] *Supra* note 8.

[21] Act, §§ 9(1), 10(1).

come because numerous Colorado taxpayers have adjusted gross incomes of less than $5,000 and do not itemize their personal deductions. Such taxpayers have no "taxable income" on their federal return. They figure their tax by applying, directly to their federal adjusted gross income, a federal table with a built-in standard deduction and deduction for exemptions. The last figure on their federal return representing the federal measure of income is therefore the federal adjusted gross income.

By copying the federal adjusted gross income figure on the Colorado return the statute automatically adopts all federal rules regarding the includability or excludability of income. For example, Colorado thereby automatically adopts the federal exclusion rules regarding dividends, sick pay, scholarships, and annuities and also adopts the six months holding period for long-term capital gain treatment. On the other hand, Colorado automatically adopts the federal rules concerning the non-deductibility of commuting expenses and the includability of alimony by the wife.

There are four[22] and *only* four modifications which are added to the federal adjusted gross income in arriving at Colorado adjusted gross income and there are eight[23] and *only* eight modifications which reduce federal adjusted gross income in arriving at Colorado adjusted gross income. The federal and Colorado adjusted gross incomes vary only if the difference is contemplated by one of the statutory modifications; if the difference is not contemplated by express statutory exception regardless of logic, equity, fairness, or any other principle, the federal and Colorado adjusted gross incomes are identical.[24] For example, because of old law differences it is entirely conceivable that a corporation could have accumulated earnings and profits of $100 for federal purposes, but of $100,000 for Colorado purposes. The tax definition of "dividend" is restricted to distributions from earnings and profits. Therefore, if the corporation were to distribute the $100,000 to a Colorado resident in a new law year, only $100 of that distribution would be a dividend and the remainder would first reduce basis of the stock to zero and the excess would be treated as capital gain. Were it not for the Act, the entire $100,000 would be a dividend. Similarly, if a Subchapter S corporation distributes $100,000 which was previously taxed to the Sub-chapter S shareholders pursuant to federal law in old law years,

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[22] The modifications discussed here are those which are incurred directly by the resident individual. Such an individual may also have similar modifications which affect his return but are incurred directly by a partnership, estate or trust. See Act, §§ 10(4)-(5).

[23] *Ibid.*

[24] Act, § 10(1).

no portion of that distribution made in the new law year would be taxed for Colorado purposes. All of it would have been taxed as a dividend by Colorado had the distribution been made in an old law year. Also, if a short-term asset is sold for 100x in a new law year which has a Colorado basis of 60x but a federal basis of 70x, then gain for Colorado purposes will be 30x and not 40x even though, had that asset been sold in an old law year, Colorado would have taxed 40x.

Numerous additional examples could be listed, but the important concept to remember is that Colorado adjusted gross income is *identical* to the federal adjusted gross income if there is no specific statutory exception which provides for a different result.

What are those specific statutory exceptions?

(a) *Modifications which increase federal adjusted gross income.*

(1) *Certain federally-excluded state interest.*[25] Federal law excludes interest paid on certain governmental obligations, *e.g.*, municipal bonds. This modification will tax such interest as well as all other interest on obligations of any state or any political subdivision thereof which interest is excluded for federal purposes. An exception to the modification was intended[26] to state that federal adjusted gross income will not be increased by interest which is specifically exempt from income tax by other Colorado statutes.

The drafters felt that Colorado should continue to tax such federally-excluded state interest to keep revenues constant.

(2) *State income taxes deducted in arriving at federal adjusted gross income.*[27] State income taxes can be deducted either as an itemized federal deduction or, under certain circumstances, as a deduction in arriving at federal adjusted gross income. Since Colorado income taxes should not be deductible in computing Colorado taxable income, if such taxes were deducted in arriving at federal adjusted gross income, they should be added back when computing Colorado adjusted gross income. Income taxes imposed by other states and deducted on the federal return are added to federal adjusted gross income because such taxes are claimed as a credit. If the Colorado oil and gas production taxes are deducted in arriving at federal adjusted gross income, said deduction is not added back in arriving at Colorado adjusted gross income.

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[25] Act, § 10(2)(a).

[26] Act, § 10(2)(a) has a misplaced comma after the word "thereof." Proposed Reg. Sec. 10(2)(a) lists such interest which is specifically exempt by Colorado Statute.

[27] Act, § 10(2)(b).

(3) *Federal net operating loss deduction.*[28] This federal deduction must be added back since Colorado has special rules for determining the operating loss deduction.[29]

(4) *Certain federal income tax refunds.*[30] Assume a taxpayer deducted federal income taxes on a prior Colorado income tax return which produced a Colorado tax benefit in that prior year. If some or all of those federal taxes are refunded (Yes, Virginia, there is a Santa Claus), the refund produces no federal income because the federal income taxes were never deductible on federal returns. Former Colorado law demanded that this federal refund be treated differently on the Colorado return and that it should be taxed. This modification continues the difference because it was felt that to do otherwise would substantially reduce state revenues.

(b) *Modifications which decrease federal adjusted gross income.*

(1) *Certain interest on federal obligations.*[31] Federal law taxes interest on federal obligations issued after September 1, 1917, with stated exceptions. It was thought necessary because of the constitutional prohibition against state taxation of federal debt to exempt all such interest income from federal obligations.[32]

(2) *Interest income on certain federal agency obligations.*[33] This section is intended to exempt interest paid by federal agencies which is subject to federal tax but which constitutionally must be free of Colorado tax. The rationale for this modification is the same as that for federal obligation interest.

(3) *Certain pension and retirement payments.*[34] Federally, *all* pensions are taxable except those relating to social security and railroad retirement. Congress enacted the retirement income credit to give other pension income similar tax-free status. Recall that the Act ties Colorado measure to federal measure and does not tie Colorado rate to federal rate. Accordingly, federal credits are not incorporated in the Act.

The Colorado modification for exclusion of certain pension and retirement payments caters to those benefits which are substantially in lieu of social security coverage, *e.g.*, state and public employees' retirement act payments, public school teachers' retirement

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[28] Act, § 10(2)(c).
[29] Act, § 59, discussed at 350-51, *infra.*
[30] Act, § 10(2)(d).
[31] Act, § 10(3)(a).
[32] See note 19 *supra.*
[33] Act, § 10(3)(b).
[34] Act, § 10(3)(c).

fund payments, faculty emeritus fund payments, police and firemen's retirement benefits, and civil service retirement benefits. It is cautiously stated that this modification applies to certain retirement benefits which are "substantially" in lieu of social security coverage. In reality an employee can conceivably receive one or more of these special retirement benefits and also receive social security benefits as a result of simultaneous multiple employment or working for different kinds of employers during separate periods of the employee's productive life span. Union members receive union-negotiated pension payments in addition to social security benefits.

Theoretically, if the Colorado law exempts social security benefits, only other retirement benefits which are in lieu of and not in addition to social security should be exempt. From a practical standpoint, proponents of the Act had sufficient problems without incurring the wrath of groups representing civil service, public, state, police, fire, teaching, university, and union employees for the sake of the philosophical symmetry in the exclusion area.

(4) *Basis adjustments.*[35] As a result of former law, taxpayers can have a federal basis of property which differs from the Colorado basis for many reasons, including different depreciation methods, original acquisition which preceded March 1, 1937, or joint tenancy property acquired by the surviving joint tenant. The drafters felt that it was imperative for Colorado taxpayers to adopt the federal basis for Colorado depreciation computations in new law years regardless of the fact that the Colorado basis differs from the federal basis. The drafters also believed that the difference in Colorado and federal basis should be accounted for, if at all, only in the year of disposition of the asset.

If, in the year of sale, a taxpayer has an asset which has an adjusted basis of 80 for federal purposes but 90 for Colorado purposes and that asset is sold for 90, the federal adjusted gross income carried to the Colorado return will show a gain of 10 (the gain will be 5 if the disposition is treated for federal purposes as a long-term capital gain transaction). The modification provides that there will be no gain for Colorado purposes and therefore 10 (or 5 if the disposition produced long-term capital gain) is subtracted on the Colorado return from the federal adjusted gross income. Were it not for this modification, Colorado would be taxing capital and not income.

This adjustment is a one-way street in favor of the taxpayer. If the Colorado basis is less than the federal basis there is no in-

[35] Act, § 10(3)(d).

creasing modification to federal adjusted gross income. This result was intentional. The drafters provided for modifications which for one reason or another they felt were mandatory. To deny a taxpayer a reducing modification would amount to an unconstitutional tax on capital. It was believed that the potential loss of revenue inherent in a case in which the Colorado basis was less than the federal basis was not sufficient to warrant complicating the law, accounting records, and tax reporting.

(5) *Annuities and amounts necessary to prevent double taxation.*[36] Former Colorado law, but not federal law, dictated that income and expenses of a decedent had to be accrued on the decedent's last return. Therefore, if a decedent had died in an old law year his personal representative would have been forced to accrue all income which was receivable but not received even though the decedent had been a cash basis taxpayer. Were the receivable collected in a new law year, the federal adjusted gross income of the recipient would include such receipt as income in respect of the decedent.[37] The adoption of federal adjusted gross income with no modification would subject such income to double taxation by Colorado.

Similarly, former Colorado law followed pre-1954 federal law regarding the taxation of annuities. Colorado law dictated that 3 per cent of the cost of an annuity was income to the recipient, whereas present federal law abandons the old 3 per cent rule and provides that only a prorated portion of the excess of the expected return over cost is income.[38] If, applying the different rules, a taxpayer had reported the following annuity income:

Year	*Colorado*	*Federal*
1960	$1,000	$ 500
1961	1,000	500
1962	1,000	500
1963	1,000	500
1964	1,000	500

he would have, as of the effective date of the Act, reported $2,500 more income to Colorado than he had on his federal return. If he were to report $500 in his 1965 federal return with no modification to reduce his federal adjusted gross income for Colorado tax purposes, he would be taxed on total Colorado annuity income, which would exceed total federal annuity income, and would be paying tax on that $500 once again. The proposed regulations state that he

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[36] Act, § 10(3)(e).
[37] INT. REV. CODE OF 1954, §§ 61(a)(14), 691(a).
[38] *Id.* § 72(b).

will have a $500 modification in each of the years 1965, 1966, 1967, 1968, and 1969.

In order to prevent the constitutional objection of double taxation in situations such as those described above, the federal adjusted gross income is reduced for Colorado purposes by any item of income already taxed by Colorado under former law. This modification, just as the basis adjustment, is a one-way street in the taxpayer's favor. Again the result was intentional; the reasons for the one-sided benefit to the taxpayer discussed in relation to the basis adjustment apply with equal vigor here. Therefore, although federal adjusted gross income will be adjusted downward if we have income in respect of a decedent which was accrued pursuant to Colorado law, there is no upward adjustment provided for deductions in respect of a decedent which have been previously deducted from the decedent's former law accrual basis return.

(6) *Refunds of state income taxes.*[39] Income taxes paid to Colorado and other states are deductible on the federal return but are not deductible on the Colorado return.[40] If all or a portion of such state income taxes are subsequently refunded (Yes, Virginia, there is also a State Santa Claus.) the amounts refunded must be included in the taxpayer's federal adjusted gross income. Were it not for this modification, such state taxes although not deductible on the Colorado return when paid would be income when refunded. This would amount to double taxation by Colorado: first, paying tax on income used to pay a tax to a state and second, paying a tax on the portion of that same tax when it is refunded. Therefore, federal adjusted gross income is reduced by the amount of such refunds or credits in arriving at Colorado adjusted gross income.

(7) *Net operating loss deduction.*[41] The function of the net operating loss, hereafter called NOL, deduction is to cause the government to be a taxpayer's partner in bad times as well as good. Federal law provides that the NOL may be carried back three years prior to the loss year and carried forward five years subsequent to that loss year as a deduction which offsets ordinary income dollar for dollar.[42] The federal NOL deduction produces tax refunds from the prior years when the taxpayer was making money and further reduces future years' income in order to recoup a portion of the loss incurred in the loss year. Pursuant to former law Colorado was a somewhat restrained partner. It allowed no carryback; the carry

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[39] Act, § 10(3)(f).
[40] Act, §§ 10(2) b, 13(3).
[41] Act, §§ 10(3) (g) and 59.
[42] INT. REV. CODE OF 1954, § 172(a) and (b).

forward extended to only four years; $2,000 of the carry forward was wasted if the carry forward produced no tax benefit; and, of greatest importance, the NOL offset capital gains and only $2,000 of ordinary income in the carry forward years.

The Act permits the deduction to be used as it is federally with the following exceptions: First, a NOL will not be carried back to an old law year,[43] *e.g.*, a 1965 NOL can be carried back to no year but will be usable in 1966, 1967, 1968, 1969, and 1970; a 1966 NOL can be carried back to 1965 and carried forward through 1971; a 1967 NOL can be carried back to 1965 and 1966 and carried forward through 1972. The reason for this exception was that the drafters did not want to jeopardize past income of the state treasury received pursuant to former law. Second, if a taxpayer incurred a NOL in an old law year, the amount of the NOL and the number of carry forward years are to be determined in accordance with former law.[44] For example a NOL incurred in 1962 of $100,000 would have been carried forward in 1963 and 1964 and the unused excess will be available to offset ordinary income only in 1965 and 1966. Third, if a business has some income which is not allocated to Colorado the amount of the NOL deduction is the portion of the NOL allocated to Colorado in the year of loss.[45] If a corporation generates a $100,000 federal NOL with Colorado allocated income being $1 and non-Colorado source loss being $100,001, the Colorado NOL deduction would be zero.

(8) *Oil Shale modifications.*[46] This adjustment is the perfect example that by this Act our legislature has not surrendered its legislative power to Washington. The modification, which was not a part of the proposed bill submitted by the bar and the accountants, was enacted by the House of Representatives because it was reported (1) that our Washington representatives wanted a more liberal state tax law to convince Congress that it should liberalize the corresponding federal rules and (2) that the then unborn oil shale industry required tax assistance to ease birth pains. I must admit that this lawyer, who receives no depreciation, depletion, or intangible drilling expense type deduction for his preparation-investment, still wonders whether this difference between federal and Colorado treatment is justified. Will this adjustment truly spell the difference between oil shale life or death? Will this adjustment be the moving cause which forces such industry to come to Colorado which to-

[43] Act, § 59(2).
[44] Act, § 59(4).
[45] Act, § 59(1).
[46] Act, § 10(3)(h).

gether with Wyoming and Utah has substantially all the oil shale deposits in the United States?

The effect of the modification is to reduce federal adjusted gross income by a depletion deduction computed at 27½ per cent instead of the federal 15 per cent and to adopt as the measure to which the increased depletion rate is applied the value of the shale after it has been reduced to oil.

5. *Colorado Deduction.*

We have stated that the first significant figure on the Colorado return is the federal adjusted gross income total which is copied from the federal return. Most taxpayers' returns will be prepared with no modifications to the federal adjusted gross income and in such instances the preceding discussion has only academic interest. The "bread and butter" of the Act follows.

By incorporating federal adjusted gross income Colorado automatically adopted federal rules concerning, *inter alia,* what income is includable, what income is excludable, what trade or business deductions would be allowed, the determination of whether income or loss is ordinary or capital, holding periods, bases, and depreciation. The Colorado deduction adopts federal rules regarding the so-called "personal deductions" such as interest, medical expenses, charitable contributions, bad debts, losses, and alimony. In the Colorado adjusted gross income area we determine what, how much, and when something is income. In the Colorado deduction area we determine what, how much, and when we can deduct so-called "non-business deductions."

(a) *Colorado Standard Deduction.* The Colorado deduction[47] is claimed in one of two ways. First, the taxpayer may automatically claim the standard deduction[48] which is the sum of the federal income tax deduction discussed below and generally 10 per cent of Colorado adjusted gross income limited to $1,000 ($500 for a married taxpayer who files separately). This general rule is subject to the following exceptions:

(1) Unmarried individuals whose Colorado adjusted gross income is less than $10,000 must use a special table promulgated by the director.[49]

(2) A married individual (i) who files jointly and whose Colorado adjusted gross income is less than $10,000 must use the

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[47] Act, §§ 9(1), 11 and 13(1).
[48] Act, §§ 11, 12(1)-(2).
[49] Act, § 12(3).

special table or (ii) who files separately and has Colorado adjusted gross income of less than $10,000 must also use the table.[50]

The Act places increased emphasis on the standard deduction and de-emphasizes itemized deductions. Under former law, an individual could itemize even if he did not itemize on his federal return and further, either spouse could compel the other spouse to itemize. The Act declares that if a taxpayer does not itemize on his federal return he must use the Colorado standard deduction[51] and further dictates that either spouse can compel the other spouse to use the standard deduction.[52]

This shift in favor of the standard deduction was enacted in order to simplify the preparation and auditing of returns. Simplification results not only from the obvious fact that one standard deduction is easier to administer than composite itemized deductions but also because the Colorado itemized deduction is tied to the federal itemized deduction. If a tax payer used the federal tables or the federal standard deduction, to what would the Colorado itemized deduction be tied?

We indicated that the Colorado deduction could be claimed in two ways: by use of the Colorado standard deduction or in certain circumstances by use of the Colorado itemized deduction. If the taxpayer itemized his deductions on his corresponding federal return and, in the case of spouses who file separate returns, the taxpayer's spouse does not elect the standard deduction by use of a table or otherwise, such taxpayer may elect the Colorado itemized deduction.

(b) *Colorado Itemized Deduction.*[53] The Colorado itemized deduction is the total of his so-called federal "page 2" deductions, *e.g.*, personal interest and taxes, medical expenses, charitable contributions, alimony, etc., with certain modifications. By starting with the total of the federal itemized deductions the Act again implements

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[50] Act, § 12(2)(b) and (3). A significant drafting error possibly occurs in this section. The intent of the drafters was clearly to limit married taxpayers to a standard deduction equal to federal income taxes plus a maximum of $1,000.00 whether they file separately or jointly. The wording of Act, § 12(2)(b)(ii) unfortunately can be interpreted to provide a combined standard deduction of federal income tax plus more than $1,000.00 if husband and wife file separately and one spouse has Colorado adjusted gross income of more than $9,999.99 and the other has Colorado adjusted gross income of more than $5,000.00 and less than $10,000.00. The low income spouse might urge that she should use a table which provides a deduction in addition to federal income taxes of between $500.01 and $999.99. The Act should be amended to limit such low income spouse to federal income taxes plus a maximum of $500.00.

[51] Act, §§ 11 and 13(1).

[52] Act, §§ 11 and 13(2)(a).

[53] Act, § 13.

the decision to tie the Colorado measure to the federal measure. It automatically adopts all federal rules regarding such determinations as the type and amount of medical expenses which may be deducted, the limitations of charitable deductions, the deductibility of alimony by the payor, and the types of state and local taxes which may be deducted.

There is one and *only* one modification which reduces the federal itemized deduction total thereby increasing Colorado taxable income. There are two and *only* two modifications which increase the federal itemized deduction total thereby decreasing Colorado taxable income.

(1) *Modification reducing the total federal itemized deduction.*[54] Included in the taxpayer's federal "page 2" deductions are property, sales, gasoline, and income taxes imposed by Colorado and other state and local taxing jurisdictions. All *income* taxes imposed by Colorado or any other taxing jurisdiction which were deducted in the federal return are subtracted from the federal itemized deduction total. The Act carves out Colorado income taxes because in order to keep revenues constant it must continue to deny the deductibility of the Colorado income tax on the Colorado return. The statute denies the deductibility of other taxing jurisdictions' income taxes because such taxes reduce the Colorado tax by way of credit.[55]

(2) *Modifications increasing the total federal itemized deduction.*

(i) *Federal income tax.*[56] The federal government, just as our state government, denies the deductibility of its own income tax in computing that tax. This modification increases the total of the "page 2" deductions by the corresponding year's federal income tax liability. The computation of this federal income tax deduction is simplified by placing it on a mandatory accrual basis. The taxpayer will no longer be forced to add withholdings and estimate payments and subtract federal refunds for the year in question as he had to do under the former elective cash basis method of deducting this tax. Instead he will copy the net tax liability as shown on one line on his corresponding federal return and inscribe that single number as his federal income tax deduction.

The statute retains the former provision that to the extent the federal income tax liability is related to income which produces no income tax revenue for the State of Colorado, such portion of the

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[54] Act, § 13(3).
[55] Act, § 8.
[56] Act, § 13(4)(a).

federal tax liability may not be deducted.[57] Nevertheless, the deduction is continued for federal income tax liability attributable to such items as United States interest because of the fear of taxing indirectly that which constitutionally could not be directly taxed.

The simplicity of mandatory accrual of this deduction will have a one-shot adverse effect on the fisc, although because of withholding and estimated tax payments this adverse effect should not be substantial. Taxpayers who formerly claimed federal taxes on the cash basis will be permitted to deduct on their 1965 returns to be filed in 1966 not only the accrued 1965 federal income tax liability but also amounts paid on their 1964 tax liability in the year 1965, *e.g.*, the last estimate and any additional amount paid when they filed the federal return. This will result in a bunching of deductions. The alternatives were to deny such cash basis taxpayers the transition deduction entirely or to prorate said transitional amounts which would have complicated future Colorado returns. It was determined that the transitional bunching of deductions would present the fewest net problems.

(ii) *Certain taxes claimed as credit on the federal return.*[58] If a taxpayer pays taxes to a foreign country or possession of the United States on income from sources without the United States, such payments or obligations may be claimed either as deductions or credits on the federal return.[59] If the taxpayer claimed such taxes as deductions they will reduce Colorado taxable income buried either in the federal adjusted gross income or in the federal itemized deductions. If they are claimed as a federal credit, except for this modification the taxpayer would receive no Colorado tax benefit. This results because credits are claimed after the federal measure is determined.

6. *Colorado Personal Exemptions.*[60]

The Colorado personal exemption is the last item subtracted from the Colorado adjusted gross income in order to complete the Colorado adoption of the federal measure. The exemption equals the number of federal exemptions times $750. The Act thereby adopts all federal rules regarding definitions of dependent, gross income

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[57] Hopefully, the Act repudiates the clearly inequitable result of Robinson v. Colorado, 392 P.2d 606 (Colo. 1964), in which a beneficiary was disallowed approximately $33,000 of paid federal income taxes because under Colorado law that which gave rise to federal tax was deemed corpus and therefore not subject to Colorado tax at the beneficiary level although it was taxed by Colorado at the fiduciary level.

[58] Act, § 13(4)(b).

[59] INT. REV. CODE OF 1954, §§ 33, 275(a)(4) and 901.

[60] Act, §§ 9 and 14.

limitations of dependents, multiple support agreements, and dependent college students. For example, those taxpayers who formerly could deduct as a Colorado dependent an individual who had gross income of between $600.00 and $749.99 will now lose such a deduction. Those taxpayers who formerly could not deduct as a Colorado dependent an individual who was multiply supported or who was a "full-time student" will gain such a deduction.

7. *Credits.*[60a]

The Colorado tax is determined by applying the Colorado rates previously discussed to the resulting Colorado taxable income. This resulting tax is reduced by withholding or estimated tax payments and is further reduced by the credit[61] for income taxes paid to other states, the District of Columbia, and possessions of the United States. No substantive changes from former law were intended in this section.

8. *Accounting Methods and Periods.*[62]

Chaos would have resulted if the statute did not demand that the taxpayer's method and period of accounting for Colorado purposes must be the same as the federal method and period. For example, in numerous cases a taxpayer formerly used the installment method of reporting income for federal purposes but the accrual method for state purposes; the death of a partner formerly terminated a partnership's year but generally did not end the year for federal purposes. How could the Act effectively tie measure to measure without also adopting federal accounting methods and periods? The Act sets forth various transitional provisions in order to make previously diverse federal and state methods and years identical for the future.[63] The intent was to force the Colorado taxpayer to the federal method and period as soon as possible.

B. RESIDENT PARTNERS

1. *Background.*

Wholesale revisions were made in the 1954 Internal Revenue Code in the area of the taxation of partners and partnerships. Fed-

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[60a] The 1965 General Assembly added a food sales tax credit to the credits discussed in the text. The sales tax credit will be added as COLO. REV. STAT. § 138-1-18 (1963) and provides generally that resident individuals will receive an amount equal to $7.00 ($3.50 for the first taxable year ending after June 1, 1965, and before January 1, 1966) times the number of allowable personal exemptions. If said amount exceeds the tax due, Colorado will pay said excess as an overpayment.

[61] Act, § 8.

[62] Act, § 7.

[63] *Ibid.*

eral changes were made respecting contributions[64] and distributions of property,[65] transfers of partnership interests,[66] termination of partnership taxable years,[67] transactions between partnerships and partners,[68] payments to retiring or deceased partners,[69] and basis adjustments.[70] Since the Colorado law was based on the federal law as of 1937 every 1954 federal change represented at least a potential difference in the laws.

The partnership is not taxable[71] but is a tax reporting entity for federal purposes. The federal partnership return is so constructed that it shows (a) each partner's share of taxable income or loss (ordinary income less ordinary deductions)[72] as well as (b) each partner's share of items of partnership income, gain, loss, deduction, or credit which are not lumped in taxable income.[73] The partner then copies on his individual return his individual share of the partnership's taxable income and specially allocated items of gain, loss, or deduction as a part of his federal adjusted gross income. His share of credits is not a part of his federal adjusted gross income.

2. *General Provisions of Act.*

The Act adopts the federal measure in this area by dictating that the starting point of the resident partner's Colorado income is his federal adjusted gross income.[74] That federal adjusted gross income has buried in it the individual partner's share of partnership income gain or loss.

3. *Modifications of Resident Partners.*

A partnership, just as an individual, can incur those items of income, deduction, gain, loss, or credit which the Act dictates will produce Colorado results different from the federal. In the individual area federal adjusted gross income and the federal itemized deduction were modified to give effect to these differences. In the partnership area the modifications are first computed at the partnership level on the partnership's Colorado tax reporting form[75] and then each partner's Colorado adjusted gross income or Colora-

[64] INT. REV. CODE OF 1954, § 721.
[65] *Id.* § 731.
[66] *Id.* §§ 741 and 742.
[67] *Id.* §§ 706(c) and 708.
[68] *Id.* § 707.
[69] *Id.* § 736.
[70] *Id.* §§ 734(b), 743(b), 754, and 755.
[71] Act, § 25(1).
[72] INT. REV. CODE OF 1954, § 702(a)(9).
[73] *Id.* § 702(a)(1)-(8).
[74] Act, § 10(1).
[75] Act, § 26(1).

do itemized deduction is modified by including his share of such partnership modification with his other non-partnership modifications.[76] For example, assume that an individual has municipal interest of $100 individually and also is a member of a partnership of which his share of partnership income and loss is 50 per cent. Assume that the partnership realizes $1,000 of municipal interest. The Colorado adjusted gross income wil be determined by adding $100 and $500 to the individual's federal adjusted gross income.

The following modifications are the only adjustments which are possible on the Colorado partnership return: certain federally excluded interest;[77] certain interest on federal obligations;[78] interest on certain federal agency obligations;[79] basis adjustments;[80] amounts to prevent double taxation;[81] oil shale modifications;[82] and foreign taxes paid by a partnership but claimed as a credit by the partner for federal purposes.[83] The other modifications discussed under "Resident Individuals" are inapplicable by their nature. For example, state and federal income taxes are not levied or refunded on partnerships and therefore are not modifications. A partnership as such incurs no net operating loss deduction and therefore this type of adjustment is inappropriate in this area. The same reasoning applies to pension and retirement fund benefits.[84]

C. CORPORATIONS

1. *Measure.*

The Act ties the Colorado law to the federal by applying the former 5 per cent rate to the "net income of a corporation."[85] "Net income" is the corporation's federal taxable income with the modifications discussed below.

2. *Modifications.*

The federal taxable income is increased by four items:

(a) Certain federally excluded state interest discussed at page 346, *supra*.

(b) The federal net operating loss deduction discussed at page 347, *supra*.

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[76] Act, §§ 10(5) and 26(1).
[77] See page 346, *supra*.
[78] See page 347, *supra*.
[78] See page 347, *supra*.
[80] See page 348, *supra*.
[81] See page 349, *supra*.
[82] See page 351, *supra*.
[83] See page 355, *supra*.
[84] See page 347, *supra*.
[85] Act, §§ 35 and 38.

(c) Those state income taxes discussed at pages 346 and 354, *supra,* which are imposed by Colorado. The statute does not add back to the measure state income taxes imposed by states other than Colorado because such taxes which are allowed as credits to resident individuals are not credits to corporations.

(d) *Excess charitable deductions.*[86] Former Colorado law decreed that a corporation could deduct only those charitable contributions which did not exceeed 5 per cent of the corporation's net income and the excess was lost. Federal law, prior to 1964, also had a 5 per cent limitation but provided that the excess could be carried forward two years. In 1964 the carryover period was extended to five years. It was determined that future Colorado revenues should not be reduced as a result of excess corporate contributions made in 1963 and 1964. If a corporation incurs excess charitable deductions in 1965 and thereafter, the excess will be deductible in accord with the federal law.

It should be noted that no corresponding addition was made to an individual's Colorado adjusted gross income for excess charitable deductions arising in 1964. Prior to 1964, federal law prohibited the carryover of excess charitable contributions by individuals. It was believed that complicating the statute to perhaps increase revenues was not justified in the case of individuals because the excess which could conceivably affect future revenues was limited to the excess of only 1964 deductions above 30 per cent of federal adjusted gross income.

Federal taxable income is decreased by seven items:

(1) Certain interest on federal obligations discussed at page 347, *supra.*

(2) Interest on certain federal agency obligations discussed at page 347, *supra.*

(3) Basis adjustments discussed at page 348, *supra.*

(4) Amounts necessary to prevent double taxation discussed at page 349, *supra.*

(5) Those refunds of only the Colorado State income taxes discussed at page 350, *supra.* Note that refunds of income taxes imposed by states other than Colorado are not subtracted from federal taxable income because such refunds are properly income to Colorado.

(6) The Colorado net operating loss deduction discussed at page 350, *supra.*

(7) Oil shale modifications discussed at page 351, *supra.*

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[86] Act, § 38(1).

This writer believes that the statute as drafted is deficient in the following area and that corrective legislation should be enacted to effect the intent of the Act. A corporation may be a beneficiary of a trust or estate and may be a partner. Specific language should be adopted which would modify a corporation's federal taxable income by its share of the Colorado fiduciary adjustment[87] and its share of the partnership's modifications. The omission of this provision was a drafting oversight.

3. *Allocation of Multi-state Income.*

The allocation of multi-state income is particularly troublesome in the corporate area even if we ignore constitutional problems. If a resident individual has income from Colorado source and out-of-Colorado income, Colorado taxes all and he receives a credit for income taxes paid to other states. If a resident individual is a partner, he reports his full share of partnership income regardless of where that income was earned and he receives a deduction for taxes paid to other states. For non-resident individuals and non-resident partners special rules fragment Colorado source income from non-Colorado source income and the tax is paid on only the Colorado source income. The key to the allocation of multi-state income for individuals and partners is therefore the taxpayer's residence. For an individual or a partner it is relatively simple to determine whether he is a resident or a non-resident. The problem of fragmentation is further reduced from a practical standpoint because, with the possible exception of oil, gas, and hardrock mining partnerships, numerous non-resident equity owners are not involved in most businesses operated in unincorporated form. Under such circumstances the method of taxing all to a resident individual or a resident partner with a credit for taxes paid elsewhere and looking to source for non-resident individuals and non-resident partners has worked with relative practical ease.

Not so with corporations. Here the initial incidence of tax is not at the equity owner level but is instead at the composite business level. Further, more businesses with numerous equity owners involved in interstate business do so in corporate rather than partnership form. The net result is that the stakes are considerably higher in the determination of what portion of corporate multi-state income should be taxed by Colorado and what portion by other states. Additionally, the residence of a multi-state corporation is almost impossible of determination — should the criteria be the state of incorporation, the location of principal physical assets, man-

[87] See page 366, *infra*.

agement offices or payroll, the origin or destination of sales, or what? If a predominantly manufacturing state chooses to place primary emphasis on the location of the point of production should a state, if it determines that it is primarily a consuming state, be precluded from emphasizing the point of the destination of the goods? The result has been a rather topsy-turvy growth of various state allocation procedures which evidence the balancing of concepts of what is a fair allocation with the very real problem of getting as much revenue as possible from foreign non-voters. Some states permit separate accounting, some do not; some use a pure formula method of allocating income, others combine formulae with direct allocation; some formulae are based on two factors, *i.e.*, sales and property, others apply three factors, *i.e.*, sales, property, and payroll.

At the time this Act was drafted, the United States Supreme Court had upheld a tax on the net income of a foreign corporation with an in-state sales office whose orders were approved and filled out-of-state.[88] Further, the Supreme Court had refused to review a decision sustaining an income tax where the only in-state contact was the solicitation of orders.[89] Congress had passed P.L. 86-272,[90] prohibiting taxation in certain limited cases, and a congressional study group was attempting to reach some definitive conclusions to bring order from chaos.[91]

The drafting group concluded that the best way to provide for allocation of multi-state corporate income in this state of confusion was to readopt existing allocation rules and make no substantial changes. The Act therefore allocates multi-state income in basically[92] the same manner as was true under former law. The Colorado Department of Revenue has added a gloss in this area by an oral acknowledgment that it no longer considers P.L. 86-272 unconstitutional[93] and therefore it will so intepret the Act that the minimum

[88] Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

[89] International Shoe Co. v. Fontenot, 236 La. 279, 107 So. 2d 640 (1958), *cert. denied.* 359 U.S. 984 (1959)

[90] 73 Stat. 555 (1959), 15 U.S.C. §§ 381-384.

[91] The results have been published as H.R.REP. NO. 1480, 88th Cong., 2d Sess. (1964).

[92] Act, § 37. Section 37(2)(b) now declares that property shall be valued in both the numerator and denominator at the "net book value recognized for federal income tax purposes."

It may be of some historical importance to note that the Department of Revenue unsuccessfully attempted to persuade the legislature to amend the property factor by including in the numerator and denominator capitalized rentals.

[93] Evidently Colorado will abide by the decision of the Louisiana Supreme Court in International Shoe Co. v. Cocreham, 246 La. 244, 164 So. 2d

contacts set forth in P.L. 86-272 will produce no tax.

The approach of the proposed regulations in this area is of particular importance. They dictate that the first determination to be made is whether the corporation does any business out of Colorado. If it does not it will be considered a unitary business and all income will be allocated to Colorado; the allocation steps outlined below will not apply. The confusion of the following proposed regulations, admittedly taken out of context, is understandable only if the confusion in the law as pronounced by our courts and legislatures is recognized. Compare the sentence:

> Irrespective of the nature of its activities, every corporation organized for profit and carrying out any of the purposes of its organization in this State is doing business in this State.[94]

with the following sentence:

> Corporations *which have neither employees nor stocks of goods* in Colorado, and which engage in no activities here, other than the shipping of goods to customers in this State pursuant to orders received by mail, telephone or telegraph, are neither doing business nor deriving income from sources in this State and are, accordingly, not taxable under this Act.[95]

and also the following sentence:

> The term 'doing business' as used for purposes of process, or the fact that a corporation is qualified to do business in another state under the laws of such other state will have no standing under this Act.[96]

This author interprets the proposed regulations to mean that if a corporation has any contact with Colorado, Colorado will tax some or all income and it will assert no taxing jurisdiction only in the isolated case where the sole contact consists of shipping to Colorado customers pursuant to orders received, accepted, and filled out of Colorado by a corporation that has no Colorado employees and no Colorado inventory. It should be noted that such interpretation probably conflicts with P.L. 86-272 notwithstanding the oral acknowledgement to abide by P.L. 86-272, and also that tax avoidance is made possible in the following case: Assume a Colorado unitary business whose only contacts with another state, which state imposes no income tax, are (1) delivery in the other state and (2) at

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314, *cert. denied,* 379 U.S. 902 (1964), in which Colorado filed an amicus curiae brief.

[94] Proposed Reg. § 35.

[95] *Ibid.* (Emphasis supplied.)

[96] Proposed Reg. § 37.

least "one employee" in the other state. Under the proposed regulations since there is an out-of-state "employee" the sales delivery to the other state should logically be free of Colorado tax.

The proposed regulations dictate that the second determination to be made is the allocation of a corporation's income if it is determined that a corporation does some business out-of-Colorado:

(a) Dividends, gains, and losses from corporate stock, royalties, and similar intangible rights are directly allocated to the principal place of the corporation's business. (Principal place of business is interpreted to be the nerve center of the corporation.)[97] Rents and gains or losses from capital assets are directly allocated to the situs of the property producing such income or loss. (The proposed regulations include a questionable definition of rents by stating that if one of the principal business functions of a corporation is the rental of tangibles that such income is not "rent" and will not be directly allocated.)[98]

(b) The remainder of the income or loss is allocated according to a two-factor, property and sales, formula.[99]

The Act for the first time permits consolidated returns.[100] It is hoped that the final regulations, unlike the proposed regulations,[101] will permit the filing of consolidated returns if federal consolidated returns are filed.

The Act continues the former rule which has questionable constitutional validity that the above allocation procedures may be nullified by the Director if, "it shall appear to [his] satisfaction [that the general allocation statute] does not properly reflect the amount of income derived from sources within Colorado" and that in such case he is, "authorized in his discretion to determine a method of allocation or apportionment as is fairly calculated to determine the net income derived from, or attributable to, sources within Colorado."[102]

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[97] *Ibid.*

[98] *Ibid.*

[99] Proposed Reg. § 37(2).

[100] Act, § 39.

[101] "Such permission will not be granted unless it is demonstrated to the satisfaction of the director by an overwhelming preponderance of evidence that the purposes in filing such a consolidated return are legitimate business purposes, or that such consolidated return will produce a more realistic and equitable Colorado tax liability, and that the purpose is not the evasion of tax under this Act." Proposed Reg. § 39.

[102] Act, § 37(4).

D. TRUSTS AND ESTATES

1. *Background.*

Former Colorado law was based on pre-1954 federal law. The theory was that the income of a trust or estate should be taxed only once — either to the trust or the beneficiary. The fiduciary paid a tax on basically all income except for that income which was distributed or distributable to the beneficiary. Such income produced a deduction to the fiduiary and was includible by the beneficiary.

The 1954 Internal Revenue Code made wholesale revisions in this area just as it did in the partnership sections. The basic change was to give the fiduciary a deduction[103] and demand inclusion by the beneficiary[104] of all amounts paid or payable by the fiduciary, whether the source of such amounts was from income or principal (limited to the fiduciary's "distributable net income"). Distributable net income is defined[105] as taxable income modified by the deduction for distributions, the deduction for personal exemptions, certain capital gains and losses, certain extraordinary dividends and taxable stock dividends, tax exempt interest, certain income of foreign trusts, and excluded dividends.

2. *Taxation of the Resident Fiduciary.*

The Act dictates that the fiduciary copy its federal taxable income[106] as the starting point in the determination of the Colorado measure. Four modifications are made to the federal taxable income to arrive at Colorado taxable income. The rates for resident individuals previously discussed at page 342, *supra,* are then applied to the Colorado taxable income.

(a) *Colorado exemption.*[107] $750 is subtracted from the federal taxable income. This amount is equal to the former exemption allowed fiduciaries. A fiduciary must add the exemption claimed on the federal return which has reduced the federal taxable income. The addition will be $600 for an estate, $300 for a "simple trust," and $100 for a "complex trust."[108]

(b) *Basis and double taxation modifications not in distributable net income.*[109] If the trust or estate realized gain in a case

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[103] INT. REV. CODE OF 1954, § 661.
[104] *Id.* § 662.
[105] *Id.* § 643(a).
[106] Act, § 45.
[107] Act, § 45(1).
[108] INT. REV. CODE OF 1954, § 642(b).
[109] Act, § 45(2). The language of the Act is especially misleading in this section. The terms of the statute refer to all modifications described in sections 10 and 13 and are not expressly limited to the basis and double taxation adjustments. Somewhere between the submission of the "Bar Bill"

where its Colorado basis was greater than the federal basis, a modification is just as necessary as it was for a resident individual discussed at page 348, *supra.* The same holds true for a modification to prevent double taxation discussed at page 349, *supra.* The Act adopts the New York philosophy that these particular modifications will be made on the fiduciary's return only if they relate to items which are excluded from distributable net income. For example, a trust sells a capital asset for $100 which has a federal basis of $70 and a Colorado basis of $95 and was held for more than six months. The trust is either silent regarding the allocation of capital gains to corpus or income or specifies that such gains will be allocated to corpus. Federal taxable income includes a gain of $15 ($30 less $15 as a long-term capital gain deduction). The fiduciary will claim a modification of $12.50 (one-half of the difference between $95 and $70).

(c) *Fiduciary's share of fiduciary adjustment.*[110] The fiduciary adjustment and its allocation between the fiduciary and the beneficiary is discussed at page 366, *infra.*

(d) *Certain non-resident beneficiary trusts.*[111] Wyoming and Nebraska have no state income tax. Assume that a trustor made a Colorado bank trustee of a trust for the benefit of a Wyoming or a Nebraska beneficiary. Assume further than someone other than the trustee has the power to remove the principal from Colorado by revocation, removal of trustee, or otherwise, and that the income is either distributed or required to be distributed to such beneficiary. With no special rule, Colorado would tax such income. Because of the fear that such trust business would be removed from Colorado, the former law provided exemption from tax in such circumstances. The Act, with this modification, continues such exemption.

3. *Taxation of the Resident Beneficiary.*[112]

We have discussed the taxation of the resident individual, the resident partner, the corporation, and the resident fiduciary. In so

to the Colorado Department of Revenue and the printing of H.B. 1003, the words "sections 138-1-10 and 138-1-13" were inserted for the words "'section 138-1-10(3) (d) or (e)." The present statute does not implement the correct theory for two reasons, (1) the drafters intended no change from the New York approach in this area and (2) the present wording conflicts with the second sentence of section 46(2). As the statute now reads it would be possible for modifications affecting extraordinary dividends and taxable stock dividends allocable to corpus to be claimed as a modification twice.

110 Act, § 45(3).
111 Act, § 45(4).
112 Act, § 10(1).

doing, we analyzed the taxation of the resident beneficiary except for the beneficiary's share of the fiduciary adjustment. For example, the resident individual who is a beneficiary has automatically accounted for his share of the income of the estate or trust when he copies his federal adjusted gross income. The portion of such trust or estate income which he must report, except for the beneficiary's share of the fiduciary adjustment,[113] is buried in the federal adjusted gross income figure.

4. *Fiduciary Adjustment.*

In the area of partner and partnership taxation by Colorado the Act adopts the federal adjusted gross income measure at the partner level and similarly applies all modifications to that measure at the partner level. Contrariwise, in the area of corporate taxation by Colorado, we adopted the federal taxable income measure at the business level and applied all modifications to that measure at the same level.

In the area of taxation by Colorado of fiduciaries and beneficiaries, the Act creates a schizoid. It adopts federal taxable income of the fiduciary as its starting point, just as it did with corporations. The Act further adopts federal adjusted gross income of the beneficiary as its starting point, just as we did with partners. But, the modifications provided for in the Act relating to the income of an estate or trust, *i.e.*, federal interest, Colorado income taxes deducted by fiduciary, the federal income tax liability, etc., are not applied solely at the fiduciary level or solely at the beneficiary level. Instead, the fiduciary adjustment is allocated between the fiduciary and the beneficiary. What is the "fiduciary adjustment" and how do we determine what portion must be accounted for by the fiduciary and what portion by the beneficiary?

With two exceptions, the fiduciary adjustment[114] is the net total of all modifications discussed in connection with resident individuals which apply to trusts or estates whether or not such modifications relate to items which are a part of federal distributable net income. All modifications, with the two exceptions, are thrown into one pot and the potpourri is called the fiduciary adjustment. The two exceptions are the basis and double taxation modifications which are not in distributable net income.[115] These two exceptions

[113] Act, §§ 10(4) and 46.
[114] Act, § 46(2).
[115] Act, § 46(2), second sentence. This sentence was adopted from the New York Statute which, contrary to the Colorado Statute, does not permit the deductibility of the federal tax on the state return. The Colorado Department of Revenue proposes that the entire federal tax paid by the fiduciary should be a deduction to it on its Colorado return. The present wording

are not thrown into any pot for division between the fiduciary and the beneficiary; instead, 100 per cent of these exceptions are deducted by the fiduciary as discussed at page 364, *supra.*

The fiduciary adjustment is allocated between the fiduciary and the beneficiaries in proportion to their respective shares of the fiduciary's distributable net income.[116] In a simple trust, 100 per cent of the fiduciary adjustment will be allocated to the beneficiaries. In a complex trust, if the trust has $50,000 of distributable net income and distributes $10,000 to each of two beneficiaries, the fiduciary adjustment will be allocated three-fifths to the trust and one-fifth to each of the beneficiaries. Special rules are provided in the unusual case that a fiduciary generates modifications but generates no distributable net income.[117]

E. Miscellaneous

1. *Exempt Organizations.*

The Act states that organizations will be exempt from tax to the extent that they are exempt for federal purposes.[118] The proposed regulations[119] further condition exemption on the submission to the director of evidence of federal exemption. The statute makes no demand of the necessity of evidence of federal exemption, nor was it the intent of the drafters that the Colorado exemption would be denied to an organization that does in fact satisfy federal law merely because it has not formally applied for exemption from the Internal Revenue Service or has lost its letter of exemption. The Act does tax the unrelated business income of exempt organizations.[120]

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dictates that if we have a discretionary trust with $40,000 of distributable net income which pays out only $20,000 to beneficiaries, the resulting federal tax of approximately $6,000 which is incurred entirely by the trustee is deductible $3,000 by the fiduciary $\left\{ \frac{20,000}{40,000} \text{ x } 6,000 \right\}$ and $3,000 by the beneficiaries. This author agrees that section 45(2) should be amended to read:

> There shall be subtracted the modifications described in section 138-1-19(3)(d) and (e), to the extent such items are excluded from federal distributable net income of the estate or trust, and section 138-1-13(4)(a).

A corresponding change should be made to the second sentence of section 46(2). The effect of these changes would be that the entire federal income tax liability incurred by the trustee would be deductible by the trustees and such modification would not be allocated in part to the beneficiary.

116 Act, § 46(3)(a).

117 Act, § 46(3)(b).

118 Act, § 17(1).

119 Proposed Reg. § 17.

120 Act, § 17(2).

2. *Subchapter S Corporations.*

A Subchapter S corporation is not an exempt organization although it is not subject to tax so long as the federal election remains in effect.[121] The proposed regulations[122] allocate the multistate income of a Subchapter S corporation according to partnership rules and not corporation rules. Accordingly, all of his share of the Subchapter S multi-state undistributed taxable income will be taxed to a resident shareholder and only the Colorado source portion of such Subchapter S multi-state undistributed taxable income will be taxed to a non-resident shareholder.

The drafters had assumed, contrary to the proposed regulations, that multi-state Subchapter S income would be allocated as other intangible income. The drafters thought it best to tax all multi-state Subchapter S income to resident shareholders and tax no part of such income to non-resident shareholders. The drafters' thinking, contrary to that of the proposed regulations, would have relieved the corporation from allocating income if one shareholder were a non-resident and also would have denied the State any tax from a non-resident shareholder's share of Colorado source Subchapter S income. Only time will tell whether the final regulations continue the partnership-type allocation, and if so, whether the courts will sanction such an approach as a reasonable interpretation of the Act.[123]

3. *Procedure.*[123a]

As indicated in the beginning of this article, the drafters were concerned principally with the substantive changes to be made. Nevertheless, the Act does differ from former law in the procedural areas as follows:

(a) Filing requirements incorporated the federal concept of income.[124]

(b) For the first time, the director is given statutory authority to promulgate rates and tables which will allow employers to compute sliding scale state withholding by reference to federal withholding.[125]

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[121] Act, § 36.

[122] Proposed Reg. § 36.

[123] Act, §§ 10(1), 15(2).

[123a] Extensive revisions to the procedural rules were enacted by the 1965 General Assembly. These changes, which will be added as Chapter 138, Article 9, COLO. REV. STAT. (1963), affect procedural rules relating to income, gross ton-mile, passenger-mile, motor fuel, cigarette, sales, and use taxes.

[124] Act, § 65.

[125] Act, § 68(3)(a).

(c) The determination of the necessity of filing declarations of estimated tax are to be made consistent with federal law.[126]

(d) The "floor" for determining the necessity of filing an estimated tax return was raised from a yearly estimated tax of $20 to $40.[127]

(e) Extremely significant revisions were made in the area of extending the Colorado statute of limitations for assessment and refunds if the federal statute of limitations is extended.

The general federal statute of limitations[128] prohibits the assessment of federal deficiencies more than three years after the return is filed. The comparable portion of the former Colorado law[128a] and the Act[129] prolong the period of repose to four years. In addition, the former Colorado law provided:

> Any final determination of the federal net income made pursuant to the provisions of federal law under which such net income is found to differ from the net income originally reported to the federal government shall be reported by the taxpayer to the director of revenue within thirty days of receipt by the taxpayer of notice of such final determination, with a statement of the reasons for the difference, in such detail as the director may require. If from such report or from investigation it shall appear that the tax with respect to income imposed by this article has not been fully assessed, the director shall within one year of the receipt of such report or within one year of discovery of such determination, if unreported, assess the deficiency . . . . The statute of limitations shall not apply in the instance of any taxpayer who, within the time specified, fails to make a report of any such change made by the said commissioner of internal revenue, or other officer of the United States or competent authority.[130]

The Department of Revenue, by administrative fiat, placed the following interpretations on this exception to the statute of limitations:

(a) The final determination which had to be reported was the receipt of a revenue agent's proposed adjustment although it was never quite clear to this author whether the Department considered the 10-day, the 15-day, the 30-day, or the 90-day letter to be

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126 Act, § 69(1).
127 *Ibid.*
128 INT. REV. CODE OF 1954, § 6501(a).
128a Colo. REV. STAT. § 138-1-39(1) (1963).
129 Act, § 89(1).
130 COLO. REV. STAT. § 138-1-29(5) (1963).

the revenue agent's report which had sufficient authority to be deemed a final determination.

(b) Even though the four-year Colorado statute had run before the final determination, if the taxpayer did not file his report of federal change within the 30-day period, the Colorado statute of limitations was revived and would not be deemed to finally run until one year after the receipt of the report or the discovery of the federal change.

(c) If a federal change were made 46 months after the Colorado return was filed and the taxpayer duly notified the director, the statute was tolled until one year after the receipt of the notice of change.

The drafters believed the Department's interpretations to be of questionable validity at best. The Department, in the drafting stages, agreed not to contest suggested legislative changes in this area if some mechanism could be devised to extend the Colorado statute of limitations when the federal statute was prolonged. It should be noted that the Department indicated that by its acquiescence it did not mean to imply that its interpretation of former law was incorrect. The Act presently provides:

(a) If the federal statute is extended by consent or by administrative or judicial proceedings, the normal Colorado four-year statute will not expire prior to one year after the expiration of the extended federal period,[131] and

(b) if a federal final determination is not reported to the director within 30 days, the Colorado statute is tolled only from the end of that 30-day period to the time the final determination is reported or, if earlier, until the director discovers the final determination.[132] "Final determination" is, for the first time, specifically defined.[133] The drafters felt that the Department should be notified when the dispute between the taxpayer and the federal government first reaches the stage that the taxpayer is voluntarily or involuntarily committed to conclude that he must pay the proposed federal deficiency. The Act assumes that if the federal government is going to receive additional taxes then, at that point in time, Colorado should be advised of the federal change. Accordingly, final determination is defined to be the first time that the federal government can put its billing machinery into operation, *i.e.*, when the taxpayer or the government offer or accept a waiver of assessment and col-

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[131] Act, § 65(6)(e).
[132] Act, § 65(6)(d).
[133] Act, § 65(6)(b).

lection of deficiency,[134] when the taxpayer pays any additional tax,[135] or when court judgment becomes final.[136]

The drafters trust that it is now clear that a federal final determination can only toll the Colorado statute, but cannot revive it, if not reported to the director within 30 days, and then only until the final determination is reported or discovered. It should also be noted that the Act provides a two-way street so that claims for refund are timely to the extent that an assessment for deficiency would be timely.[137]

4. *Effective Date.*

Except for the withholding provisions, the Act affects taxable years beginning after December 31, 1964.[138]

IV. CONCLUSION

This writer acknowledges that the Act is not perfect and alludes to some of the sections which must be amended. Additional changes will become apparent as we work with the new law. It is hoped that such technical changes will be relatively few because of the hundreds of donated man-hours which preceded its enactment. By the same token, this writer submits that new legislatures will do the public no real service by hastily changing substantive provisions so that additional differences will be created in the federal and Colorado measure of income. The Act as drafted with mandatory technical changes will accomplish the following objectives:

1. The vast majority of taxpayers will be able to complete their Colorado income tax returns without being forced to struggle with the legion differences which formerly existed. Almost all of the information required for the Colorado returns can now be copied directly from the federal returns.

2. It is expected that the Act will broaden the base because administrative enforcement and taxpayer compliance is greater at the federal level than at the state level. The Internal Revenue Service has what to the Colorado Department of Revenue must appear to be substantial funds with which to enforce the law. Additionally, it is generally believed that taxpayers incur greater psychological trauma if they have a tendency to "fudge" federally than is true at the local level.

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134 Act, § 65(6)(b)(i), (ii), and (iii).
135 Act, § 65(6)(b)(iv).
136 Act, § 65(6)(b)(v).
137 Act, § 65(6)(f).
138 Colo. Sess. Laws 1964, ch. 95, § 4 at 810.

3. The Act will permit the Colorado Department of Revenue to economically utilize information obtained by the federal government from the federal electronic data processing equipment and federal audits to a much greater extent than was formerly possible. State machines will be able to process more information with the result that manpower can now be used more effectively. The federal information was always available but could not be economically utilized so long as there were minor but numerous differences between the federal and Colorado returns. The greater utilization of the federal by-product amounts to an indirect federal grant-in-aid.

4. The Act will promote uniformity and relative ease of interpretation by the automatic adoption of current federal regulations, rulings, and case law.

It requires no omniscience to realize that the state's need for money in many areas — including primary, secondary, and higher education, mental and physical medical services and programs, rehabilitating correctional programs and institutions — will increase. The state has but three broad-based taxes to accommodate these needs: property, sales, and income. Whether or not increased use is made of the property and sales taxes, it is fairly obvious that future additional emphasis will be placed on the state income tax. We hope that the Act, as interpreted by the Department of Revenue and the courts, will create an efficient mechanism to ensure that, whether directly paid to the government as tax or indirectly paid in the form of accounting and legal compliance costs, as much of the state imposition as possible reaches the deleted state programs and services which are demanded.

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