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FEDERAL TAX LAW CHANGES AND THEIR IMPACT ON COLORADO REVENUE

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This *Issue Brief* explores the federal tax reduction legislation passed in May 2001 and its impact on Colorado's revenue stream. State tax revenue is impacted by some federal tax cuts because Colorado's income and estate taxes are based on calculations made for determining federal taxable income and federal estate taxes. The state will see a reduction in revenue of $9.3 million in FY 2001-02, $37.0 million in FY 2002-03, and $66.9 million in FY 2003-04. When the federal tax changes are fully implemented in 2010, the state will see an annual reduction in excess of $160 million. While we do not attempt to quantify the amount, the state will see an offsetting increase in sales and other tax revenues as people in the state spend their federal and state tax savings on goods and services. If the tax cuts are repealed as scheduled on December 31, 2010, the state would see a large increase in revenue after the repeal date.

Federal Tax Cuts

Changes in the Federal Income Tax Brackets. The change in income tax brackets is the key piece of the federal government's $1.3 trillion tax cut plan that takes place over the next decade. The federal income tax structure currently has five tax brackets with rates of 15, 28, 31, 36, and 39.6 percent. The new legislation will create a sixth bracket of 10 percent for the first $6,000 of taxable income for a single person, $10,000 for a head of household, and $12,000 for a married couple. This change is retroactive to January 1, 2001.

Taxable income in the 10 percent bracket increases to $7,000 for single persons and $14,000 for married couples in 2008. Over the next six years, rates for other tax brackets will be reduced as shown in Table 1. Since Colorado's income tax system is not dependent on the federal tax brackets, these changes will not impact revenue in Colorado.

Table 1
Other Income Tax Rate Reductions

Calendar Year	28% Rate Reduced To:	31% Rate Reduced To:	36% Rate Reduced To:	39.6% Rate Reduced To:
2001[1]-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 and later	25%	28%	33%	35%

[1] Effective July 1, 2001
Source: Joint Committee on Taxation

Taxpayers will also receive a credit based on taxes paid for the 2000 tax year equal to 5 percent of the first $6,000 of taxable income for singles, $10,000 for heads of households, and $12,000 for married couples. Most taxpayers will receive their credit in the form of a check issued by the U.S. Department of Treasury in 2001.

Phase-Out of Itemized Deduction Limitations. The limitation on itemized deductions will be reduced by one-third for tax years 2006 and 2007, two-thirds for tax years 2008 and 2009, and eliminated beginning in tax year 2010. In effect, this change will increase the dollar amount of itemized deductions. Any change

that increases the amount of itemized deductions at the federal level will reduce Colorado taxable income. We estimate that the initial phase in will cost the state a half-year impact of $4.6 million in FY 2005-06, $9.4 million in FY 2006-07, and $14.5 million in FY 2007-08. After the reduction is fully phased in, state income tax collections will be reduced by over $30 million per year.

Phase-Out of Restrictions on Personal Exemptions. Limitations on the ability of taxpayers to claim personal exemptions are reduced by one-third for tax years 2006 and 2007, two-thirds for tax years 2008 and 2009, and eliminated beginning in tax year 2010. As is the case with itemized deductions, personal exemptions reduce federal taxable income prior to the determination of Colorado taxable income. We estimate that the initial phase in will cost the state a half-year impact of $1.8 million in FY 2005-06, $3.7 million in FY 2006-07, and $5.8 million in FY 2007-08. After the reduction is fully phased in, state income tax collections will be reduced by over $10 million per year.

Repeal of the Estate Tax. The estate tax is reduced between 2002 and 2009 by increasing the amount of an estate that is exempt from taxes upon death and decreasing the tax rates. The estate tax is completely repealed in 2010. Table 2 shows the amount of the exemption and the highest estate tax rate for each year until repeal in 2010. The federal tax legislation also phases out the federal credit for state taxes paid at the rate of 25 percent per year beginning in 2002. Because state estate taxes are based on the federal credit, Colorado's tax on estates will be eliminated in 2005. The state will continue to see some revenue from the tax, however, as it generally takes about nine months to settle an estate and pay taxes.

The phase out of the credit will reduce estate tax revenue in Colorado by $14.6 million in FY 2002-03, $36.6 million in FY 2003-04, and $55.0 million in FY 2004-05. The total impact of the federal changes will be slightly larger because the rate changes will further reduce estate tax receipts. The state will receive no revenue from estate taxes after FY 2006-07. The federal legislation also repeals generation-skipping transfer taxes and increases the exemption on gift taxes.

Table 2
Estate Tax Rates and Exemption Amount

Calendar Year	Estate Exemption Amount	Highest Estate Tax Rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%

Source: Joint Committee on Taxation

Marriage Penalty Relief. The marriage penalty results when a married couple pays more in taxes than two unmarried individuals with otherwise identical tax returns. A marriage penalty exists at the federal level (as well as a marriage benefit for some taxpayers) with the largest impact generally being on two-wage-earner couples who earn approximately the same income. Three actions included in the federal legislation will repeal a portion of the federal marriage penalty. First, between tax years 2005 and 2009 the **standard deduction for joint filers** will be raised so that it is double the amount of the standard deduction for a single person. This will allow a married couple to exclude the same amount of income from taxation as two single people. This change will not impact Colorado because the state enacted its own marriage penalty tax relief in 1999 (House Bill 99-1003) that accomplished the same thing in Colorado as the federal legislation is doing nationally. Second, the end point of the **15 percent tax bracket for married couples** filing jointly will be increased to

double the end point of the 15 percent tax bracket for a single person. This change will also be phased in between 2005 and 2009. Again, there is no impact on Colorado taxes because the federal tax rates are not used in Colorado. Finally, the level of the **earned-income tax credit** phase-out for married couples is increased between tax years 2002 and 2007. This change does not impact Colorado's revenue because federal credits are not applicable in the state. However, this last change will impact the amount of money refunded to taxpayers through the state's earned-income tax credit TABOR refund mechanism. Since the refund mechanism is equal to 10 percent of the federal credit, the increase in the federal credit will increase the amount refunded in Colorado. Increasing the earned-income credit refund mechanism will reduce the six-tier sales tax refund by a similar amount. We expect this change to increase the amount refunded through the earned-income tax credit refund mechanism by about $5 million per year after it is fully phased in.

Increase in the Child Tax Credit and Other Credits Benefitting Children. The federal child tax credit will be increased from $500 to $600 in tax year 2001, to $700 in 2005, to $800 in 2009, and to $1,000 in 2010. Because this credit is applied to taxes owed at the federal level and not to income as used on the Colorado income tax form there will be no impact on revenue in Colorado. The federal legislation also extends and expands the *adoption tax credit*, the *dependent care tax credit*, and the *credit for employer-provided child care facilities*. Like the child tax credit, these changes will not impact Colorado state revenue.

Education Provisions. Eight provisions are included in the legislation to provide tax breaks for education. These provisions:

- ✍ Increase contribution limits for education IRAs;
- ✍ Allow tax-free distributions from qualified tuition plans;
- ✍ Extend employer-provided assistance provisions permanently;
- ✍ Ease the rules for student loan interest deductions;
- ✍ Eliminate the tax on certain awards;
- ✍ Increase the arbitrage rebate exception for government bonds;
- ✍ Allow tax-exempt private activity bonds for education facilities; and
- ✍ Create a deduction for higher education expenses from 2002 through 2005.

The provisions that increase tax deductions or tax-free contributions or interest will reduce revenue to Colorado. We anticipate that state revenue will be reduced by $2.6 million in the first full year (FY 2002-03) and the reduction will grow to over $8 million by FY 2009-10.

Pension and Retirement Provisions. The legislation provides for increased contribution limits and catch-up provisions for IRA plans and increases contribution limits for elective deferral plans such as 401K plans. The new law also has provisions for enhancing fairness for women, increasing portability, strengthening pension security and enforcement, and reducing regulatory burdens. Because these increased contributions are generally made on a pre-tax basis, the state will see a revenue reduction of $7.2 million in FY 2002-03 and an annual impact of over $26.0 million by 2009-10.

Alternative Minimum Tax. The exemption amount for the alternative minimum tax is being increased by $2,000 for individual returns and $4,000 for joint returns for tax years 2001 through 2004. The increased exemption ends for tax year 2005. These exemptions will pass through to the state alternative minimum tax and will reduce state revenue by a maximum of $4.1 million during the affected years.