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MEMORANDUM

July 19, 2010

TO: Interested Persons

FROM: Jason Schrock, Economist, 303-866-4720

SUBJECT: History of Colorado Income Tax Rates

This memorandum provides a history of Colorado's income tax rate changes. First, the memorandum provides background information on the individual and corporate income tax, including a brief discussion on some of the major changes to the tax base that have occurred.[1] It also provides figures showing how the individual and corporate income tax rates changed over time. Finally, it discusses some of the reasons why the changes in tax rates were made.[2]

Summary

From 1937—the first year the state income tax was established—through 1986, Colorado had a graduated income tax system for individual income taxpayers. Under this system, higher levels of income were taxed at higher rates. The corporate income tax was established at a single rate, often called a "flat tax." However, graduated tax rates for corporations began to be implemented in the early 1980s. The main rationale for a graduated income tax system is to reduce the tax burden for taxpayers with lower incomes and shift the burden to those with higher incomes. This is called a progressive tax system.

Colorado moved to a single tax rate of five percent for individuals in 1987. The main reason for this change was to simplify the income tax system. Also, the lower five percent rate reduced the income tax liability overall for taxpayers which would have increased as a result of the broadening of the tax base that occurred due to federal tax reform in 1986. The corporate income tax reverted

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1 This memorandum focuses on changes in the tax rates, not other changes to the individual and corporate income tax that can impact a taxpayer's liability, which can include changes to the tax base as well as the addition or elimination of tax credits and tax deductions.

2 This information was obtained from Legislative Council Staff and Department of Revenue publications, as well as discussions with current and former staff from Legislative Council, Legislative Legal Services, the Department of Revenue, and legislators who were involved in the legislative changes.

Summary (continued)

to a single rate after the federal tax reform, though the corporate graduated rates were phased-out over several years. Since 1992, with the passage of TABOR, the state constitution requires that all taxable income be taxed at one rate. The tax rate reductions in the latter 1990s were approved to reduce the large TABOR surpluses that were occurring and that were forecast at the time to continue.

There were several other modifications to individual and corporate income tax rates over time. Most of these changes were likely made either to increase revenue, reduce taxes, enhance or reduce the "progressivity" of the tax, or to update the tax code to reflect a changing economy and income levels. The changes were likely influenced by the condition of the economy, the state's fiscal situation, and the political climate of the time.

Individual Income Tax

Background on individual income tax. The individual income tax was first levied in 1937 and currently makes up about 60 percent of General Fund revenue. Colorado is one of 43 states that levy an individual income tax, though two of these states limit the tax to a small portion of income. Like many other states, Colorado uses federal taxable income as the tax base to help determine state taxable income.

To determine individual income tax liability, federal taxable income is first modified by any additions or subtractions to this income set out in the state income tax code that applies to a taxpayer. The modified taxable amount is multiplied by the current 4.63 percent tax rate to determine Colorado gross tax liability. The gross tax liability is then reduced by any tax credits to determine the amount of taxes owed by the taxpayer to the state.

Major changes to individual income tax base. In addition to changes in the tax rates, the income tax base (or taxable income) is an important factor in determining tax liability. From 1937 to 1964, the state determined what income and activities were subject to the state income tax. In 1964, however, Colorado's income tax base became more closely aligned with the federal tax base as Colorado adjusted gross income became based on federal adjusted gross income. In 1987, state taxable income became tied to federal taxable income. This resulted in a simplified income tax system for state income taxpayers. However, because state taxable income is calculated from federal taxable income, policies made by the federal government that affect federal taxable income also impact state taxable income, and thus state taxpayers and income tax revenue to the state.

History of tax rates. Figure 1 on the next page provides information on the history of individual income tax rate changes. From 1937 through 1986, Colorado had graduated income tax rates for taxpayers with different income levels. Colorado moved to a single tax rate in 1987, often called a "flat tax," that was initially set at five percent. This rate was reduced to the current 4.63 percent in 2000. In addition to the regular income tax, from the inception of the individual income tax through 1986, a surtax of two percent was levied on income derived from dividends and interest above a certain exempt amount.

Reasons for changes to tax rates. It can be difficult to determine the precise reason(s) for each of the changes in the individual income tax rates that have occurred. First, there is often a lack of adequate records on legislative deliberations several years ago and these records can be subject to different interpretations. Also, legislators may have had different reasons for the tax changes. For example, one group of legislators may have voted for a tax rate increase solely to increase state revenue, while other legislators may have voted for the change for other reasons, such as to make the tax system more "progressive." Despite this difficulty, the discussion below provides information on some of the main reasons for the major changes in the income tax rates over time.

The state's initial graduated individual income tax system. The state's first individual income tax rates were graduated, or progressive, meaning that taxpayers with higher income paid higher tax rates. The main rationale of a graduated income tax system is to reduce the tax burden for people with lower incomes and shift the burden to those with higher incomes. In a graduated system, tax liability as a percentage of income rises with higher incomes.

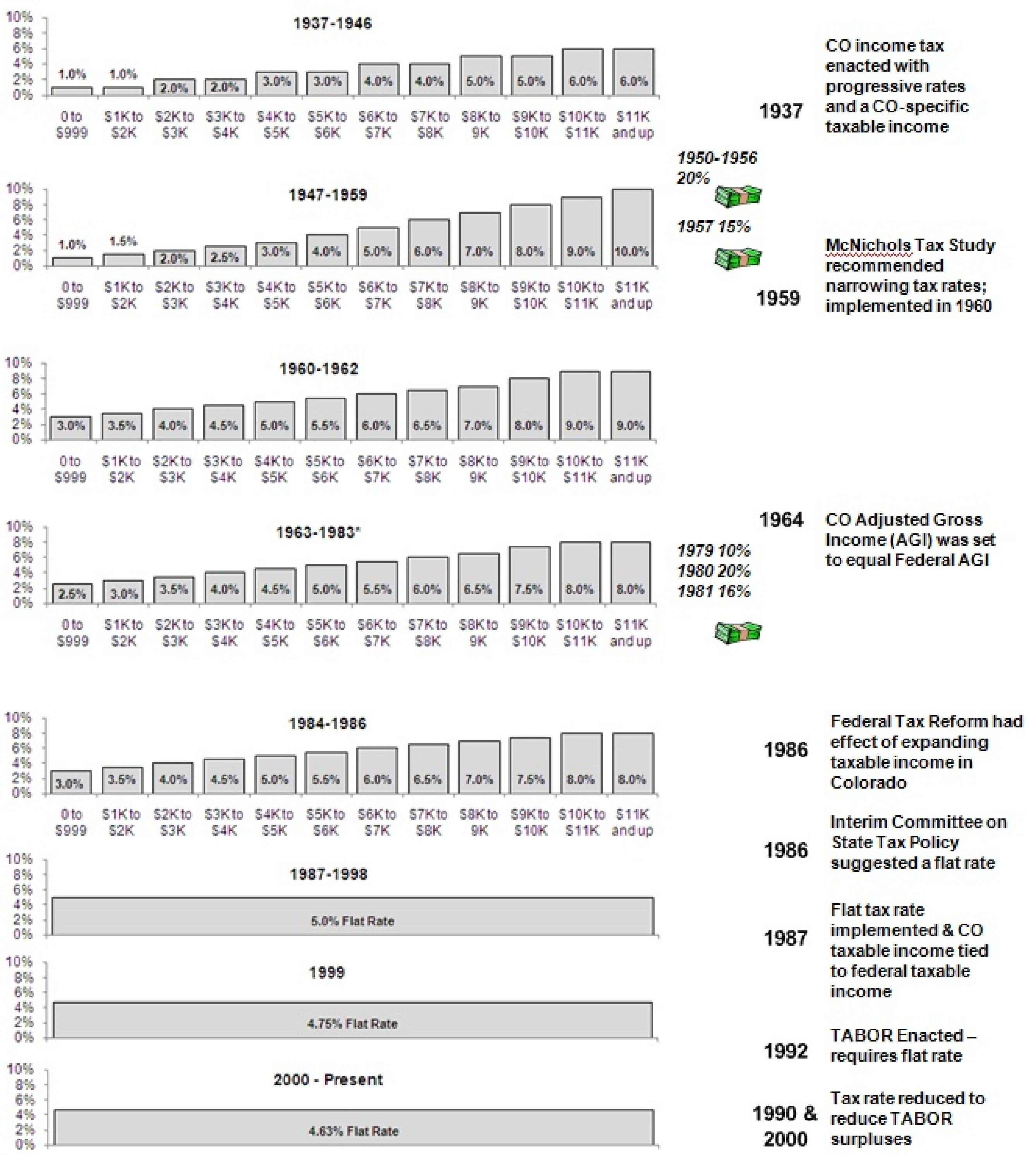
At the time of the introduction of the state income tax, Colorado's combined state and local tax structure was viewed as regressive. A regressive tax system imposes a greater burden on low income taxpayers than on higher income taxpayers because the tax liability comprises a larger portion of the lower income taxpayer's resources. Thus, the implementation of graduated individual income tax rates in 1937 was, at least in part, intended to introduce more progressivity into the state's tax system.

Narrowing of the tax rates in 1960. One of the recommendations of the 1959 McNichols study of the state's tax structure, "Financing Government in Colorado," was to reduce the progressivity of the individual income tax and make it more "fair and productive." To achieve this, the study recommended narrowing the tax rates by raising the lowest rate to three percent, raising the subsequent rates, and capping the maximum tax rate for all income over $10,000. This recommendation was adopted by the legislature and implemented starting with 1960 as shown in Figure 1.

Change to a single rate. A single, or flat, income tax rate of five percent was enacted for individual income taxpayers in 1987 by the *Tax Equity Act of 1987*.[3] The origin of this legislation can be traced to a recommendation of the 1986 Interim Committee on State Tax Policy. One of the activities of the committee was to study the state income tax system, especially in light of the federal tax reform of 1986. The report of the interim committee stated that the single rate was recommended to simplify the income tax system and reduce the costs of administering the tax.

3 House Bill 87-1331

Figure 1. History of Colorado Individual Income Tax Rates



This symbol indicates that a tax credit equal to the percentage of tax liability was provided to all taxpayers in the applicable year. For example, in 1980 taxpayers were able to claim a credit of 20% of their tax liability.

In addition to the regular income tax, from the inception of the individual income tax through 1986, a surtax of two percent was levied on income (above a certain amount) derived from dividends and interest.

**Tax rates for 1963 to 1983 for incomes up to $9,000 were actually the same as those in the previous and immediately following periods shown above. However, a ½ percent credit was applied for incomes up to $8,999 during 1963 through 1983, making the rates effectively equal to those shown.*

In 1960, the highest tax bracket of $11,000 and over was eliminated, and all income $10,000 and over was taxed at the same rate. The tax brackets were adjusted for inflation in certain years between 1978 through 1986. This was intended to prevent taxpayers from moving into higher tax brackets solely as a result of inflation.

One other main purpose of the tax change to a lower single rate was to reduce the income tax liability for taxpayers overall. The federal income tax reform of 1986 resulted in an expansion of the income tax base by both limiting and eliminating several tax deductions. Thus, without a change in the state's income tax rates, the state's taxpayers would have experienced higher tax liabilities. The single five percent tax rate resulted in lower tax liabilities for many taxpayers than if the tax rates had remained the same. However, even with the lowering of the tax rate, taxpayers overall still experienced higher tax liabilities as a result of the federal tax reform and the state experienced a revenue increase.[4]

State constitutional requirement of a single income tax rate. Since the passage of TABOR in 1992, the state constitution requires that any income tax law change must require that the state tax income at one rate (Article X, Section 20 (8) (a), Colorado Constitution).

1999 and 2000 tax rate reductions. The main reason for the reductions in the tax rate in 1999 and 2000 was to reduce the TABOR surpluses that were occurring. Legislators voting for the reductions believed that the state did not need to collect the income tax revenue that was going to be refunded. Therefore, reducing the rate was a way to reduce refunds. Revenue forecasts at the time projected continuing surpluses.

Other changes in tax rates. Besides the more substantial changes to the individual income tax rates discussed above, income taxes were modified in other ways over time. Some of the changes were perhaps made to increase revenue, others were to reduce taxes, and others were to just update the tax code to reflect a changing economy and income levels. For example, it is reasonable to conclude that the tax credits during the 1950s and from 1979 to 1981 were put in place to provide income tax relief to taxpayers at a time when the state had sufficient revenue to do so. Further, there was a one-half percent tax credit from 1963 to 1983 for most tax brackets that was likely put in place to reduce the income tax liability for certain groups of taxpayers. However, most of these credits were eliminated when the state experienced fiscal problems.

Corporate Income Tax

Background on corporate income tax. Colorado is one of 46 states that have a corporate income tax. Colorado adopted a corporate income tax along with its individual income tax in 1937. As with individual income taxes, the starting point for calculating Colorado taxable income for corporate income tax purposes is federal taxable income, modified by any additions or subtractions to this income. As with the individual income tax, the corporate income tax base likely did not always use federal taxable income as its starting point for determining state taxable income. Colorado taxable income for corporations is determined by the proportion of the corporation's income generated by sales in the state. Colorado taxable income is then multiplied by the 4.63 percent tax rate to determine Colorado gross taxable liability. The gross tax liability is then reduced by any tax credits to determine the amount of taxes owed to the state.

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[4] The Department of Revenue and the Office of State Planning and Budgeting estimated in a March 1992 study, "Colorado State and Local Finance Study," that the state received an additional $475.5 million from taxpayers from 1987 to 1990 as a result of the broadening of the tax base resulting from the federal tax reform, even with the enactment of a lower five percent rate. The department also estimated that the lower five percent single rate (and certain tax base adjustments) reduced the tax liabilities of taxpayers by $631.5 million.

Recent changes to tax base. House Bill 08-1380 required that business income for multi-state corporations and partnerships be apportioned to Colorado based on the ratio of a company's sales in Colorado to its total sales. Previously, corporations and partnerships had a choice regarding apportionment methods based on an average of certain factors, including the proportion of property, sales, receipts, or employee compensation in Colorado of the company's total. This change resulted in an increase in tax liabilities for some corporations and a decrease for others.

History of tax rates. Figure 2 provides information on the history of corporate income tax rate changes. Unlike individual income taxes, the corporate income tax did not start out with graduated rates. However, a graduated tax rate was in place for corporate income taxpayers for 1981 and 1982 and from July 1, 1986 to June 30, 1993. The corporate income tax has been at a single rate since July 1, 1993.

Change from a single tax rate to graduated tax rates. Corporations were not taxed at graduated rates at first as individual income was. Staff did not identify a documented reason for why this was the case. It is possible the legislature did not believe that having a progressive income tax system was as important for corporations as it was for individuals.

Graduated income tax rates for corporations were first implemented in 1981. These graduated rates served to reduce the tax liability of corporations as lower tax rates were put in place for lower income levels. These lower rates were implemented at a time when the state economy and tax revenue to the state was robust due to the state's energy boom.

Temporary change to single rate starting in 1983. The graduated corporate income tax rates changed back to a single rate temporarily starting in 1983. This tax rate change served as a tax increase as the lower rates were removed. The tax increase was intended to increase state revenue as the state was experiencing an economic downturn and fiscal issues.[5] The single rate was scheduled to remain in effect through 1987 and then revert back to lower graduated rates similar to those in place in 1981 and 1982.

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[6] The bill that changed the corporate tax rate also temporarily raised the state sales tax rate from 3.0 percent to 3.5 percent.

Figure 2
History of Corporate Income Tax Rates

Taxable Periods Beginning:	Tax Rate:
January 1, 1937 to December 31, 1946	4.0%
January 1, 1947 to December 31, 1950	5.0%
January 1, 1951 to December 31, 1956	5.0%, with a 20.0% credit
January 1, 1957 to December 31, 1957	5.0%, with a 15.0% credit
January 1, 1958 to December 31, 1980	5.0%
January 1, 1981 to December 31, 1981	4.0% on first $25,000; plus 4.5% on income between $25,000 and $50,000; plus 5.0% on income above $50,000
January 1, 1982 to December 31, 1982	4.0% on first $25,000; plus 4.5% on income between $25,000 and $75,000; plus 5.0% on income above $75,000
January 1, 1983 to June 30, 1986	5.0%
July 1, 1986 to June 30, 1987	5.25% on first $50,000; plus 5.5% on income between $50,000 and $200,000; plus 6.0% on income above $200,000
July 1, 1987 to June 30, 1988	5.5% on first $50,000; plus 6.0% on income above $50,000
July 1, 1988 to June 30, 1989	5.0% on first $50,000; plus 5.5% on income above $50,000
July 1, 1989 to June 30, 1990	5.0% on first $50,000; plus 5.4% on income above $50,000
July 1, 1990 to June 30, 1991	5.0% on first $50,000; plus 5.3% on income above $50,000
July 1, 1991 to June 30, 1992	5.0% on first $50,000; plus 5.2% on income above $50,000
July 1, 1992 to June 30, 1993	5.0% on first $50,000: plus 5.1% on income above $50,000
July 1, 1993 to December 31, 1998	5.0%
January 1, 1999 to December 31, 1999	4.75%
January 1, 2000 and after	4.63%

Graduate tax rates implemented in 1986. Legislation in 1986 amended the corporate income tax rate that was scheduled to remain at a single rate through 1987 back to a graduated rate starting July 1, 1986. As shown in Figure 2, the graduated rates were higher tax rates than the single five percent rate. Again, these rate changes were implemented as a measure to deal with state fiscal problems as the state was experiencing a major economic downturn.

Phased-in of single rate. The Tax Equity Act of 1987—the same legislation that made the individual income tax a single five percent rate—also phased-back in a single rate for corporate taxpayers to a five percent rate. As shown in Figure 2, implementation of this change was phased-in over a period of seven fiscal years starting July 1, 1987. The corporate income tax rate became a flat five percent starting July 1, 1993.

Again, a main goal of the sponsors of the Tax Equity Act of 1987 was to simplify the state income tax system and a single rate was one way to achieve this goal. Also, since the tax rate for individuals was changed to a single five percent rate in the legislation, at least some of supporters of the corporate tax rate change likely believed that corporations also should be taxed at the same rate. The single rate was likely phased-in over time because of the revenue impacts of lowering the graduated tax that had rates above five percent to a single five percent rate.