

Tax Expenditures **Compilation Report**



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OFFICE OF THE STATE AUDITOR

C O L O R A D O

Working to improve government for the people of Colorado.

OFFICE OF THE STATE AUDITOR

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Tax Expenditures

Overview

Senate Bill 16-203 (codified at Section 39-21-305, C.R.S.) requires the State Auditor to review all of the State’s tax expenditures at least once every 5 years and to issue a report no later than September 15 each year that includes the tax expenditures reviewed during the preceding year. This report, the sixth issued under this requirement, contains all of the tax expenditure evaluations completed from September 16, 2022, through September 15, 2023. House Bill 21-1077 established the Legislative Oversight Committee Concerning Tax Policy, which is responsible for reviewing the policy considerations included in tax expenditure evaluations completed by the Office of the State Auditor.

What is a tax expenditure?

Statute [Section 39-21-302(2), C.R.S.] defines a tax expenditure as “a tax provision that provides a gross or taxable income definition, deduction, exemption, credit, or rate for certain persons, types of income, transactions, or property that results in reduced tax revenue.” Although tax expenditures are not subject to the State’s annual budget and appropriations process, they are known as “expenditures” because they decrease available state funds similarly to appropriated expenditures by reducing the amount of state revenue collected, as opposed to spending revenue that has been collected.

Taking into consideration the language used in Senate Bill 16-203, which directs the Office of the State Auditor (OSA) to conduct evaluations of all of the State’s tax expenditures, the OSA interpreted the definition of tax expenditure to include four elements:

1. It must be a state provision, enacted by state law, not federal or local laws.
2. It must be a tax provision that provides a deduction, exemption, credit, rate, allowance, or taxable income definition, and not be related to a fee.
3. It must only apply to certain types of persons, income, transactions, or property, thereby appearing to confer preferential treatment to specific individuals, organizations, or businesses.
4. It must potentially result in reduced tax revenue to the State (i.e., the provision must affect state revenue, not just local government revenue); the State must legally be able to collect taxes from

the person, or on the income, transaction, or property; and the provision must be administered outside of the State's annual budget, appropriations, and spending process.

Based on the OSA's interpretation of statute [Section 39-21-302(2), C.R.S.] and Senate Bill 16-203, the OSA did not consider the following provisions to meet its definition of a tax expenditure:

- Federal tax provisions and local tax provisions that are left to the discretion of local governments under current law (e.g., local sales, use, special district, income, and property tax ordinances).
- Provisions related to fees that operate similarly to a tax, but have not been considered taxes for purposes of the Taxpayer's Bill of Rights (TABOR).
- The State's decision to use Federal Taxable Income as the basis for calculating state income tax since the use of Federal Taxable Income applies to all taxpayers. This decision effectively provides taxpayers with most federal deductions at the state level.
- Property tax exemptions created by the General Assembly that only apply to local governments.
- Colorado's Tribal Income Tax Exemption because federal law prohibits state taxation of tribal income.

Exhibit 1 provides information about the types of tax provisions included in the definition of tax expenditures.

Examples of Tax Expenditures

Credit

Reduces tax liability dollar-for-dollar. Some credits are refundable, meaning that a credit in excess of tax liability results in a cash refund.

Example: Taxpayers with children under age 13 may receive a credit for a percentage of childcare expenses.



Deduction

Reduces gross income due to expenses taxpayers incur.

Example: Taxpayers may be able to deduct a percentage of the costs they incur for wildfire mitigation.



Income Definition

Excludes income that would constitute part of a taxpayer's gross income.

Example: Employees do not pay taxes on contributions employers make to medical savings accounts.



Exemption

Reduces gross income for taxpayers because of their status or circumstances.

Example: Alcoholic beverages produced for personal consumption are exempt from sales and use taxes.



Tax Rate

Reduces tax rates on some forms of income.

Example: Insurance companies with an office in Colorado may be eligible for lower insurance tax rates.



Tax expenditures may be enacted to achieve a variety of policy goals. For example, some tax expenditures, referred to in this report as “structural tax expenditures,” are intended to establish the basic elements of a tax provision, avoid duplication of a tax, promote administrative efficiency, clarify the definition of the types of transactions or individuals who are subject to a tax, or ensure that taxes are evenly applied. A sales tax exemption for wholesale transactions is an example of a structural provision since it is intended to avoid the repeated application of the sales tax to the same good as it moves through the supply chain (e.g., from manufacturer to wholesaler, or from wholesaler to retailer). In contrast, other tax expenditures, sometimes referred to as “preferential tax expenditures,” may be intended to promote certain behaviors, promote fairness, or stimulate certain types of economic activity. For example, a tax credit for property owners who complete restoration projects on historic properties may be intended to encourage property owners to complete such projects.

The benefit, and therefore relative incentive, provided to taxpayers from each type of tax expenditure varies based on the operation of the tax expenditure and taxpayers’ individual circumstances. Some key considerations include:

- **Type of Tax Expenditure.** The type of tax expenditure can have a large impact on the potential benefit to taxpayers. For example, deductions, which reduce taxpayers’ taxable income, are most beneficial to taxpayers with higher incomes, whereas taxpayers who have taxable income that is already lower than the available deduction would see less benefit. Similarly, credits, which directly reduce the amount of tax owed, may be more beneficial to taxpayers with higher tax liabilities.
- **Refundability.** Tax expenditures that are refundable, meaning that taxpayers can claim a refund for the amount that exceeds their tax liability, are generally more beneficial than non-refundable tax expenditures, especially when taxpayers otherwise owe less in taxes than the benefit provided by the tax expenditure.
- **Carryforwards.** Carryforward provisions allow taxpayers to apply unused portions of a tax expenditure to future years. Such provisions can increase the benefit to taxpayers who may not be able to claim the full value of the tax expenditure in one year.
- **Transferability.** Some tax expenditures allow taxpayers to sell the right to claim the tax expenditure to another person or business entity. Such provisions tend to be beneficial to taxpayers who have an immediate need for funds or who would otherwise not be able to claim the full amount of the tax expenditure.
- **Caps.** Some tax expenditures are capped, meaning that a taxpayer can only claim up to a specified amount. Caps limit the benefit provided to a taxpayer and tend to make tax expenditures relatively less attractive to taxpayers who have high incomes and high tax liabilities.

How do tax expenditures impact Colorado’s state and local tax system?

Tax expenditures reduce both state and local tax revenues in Colorado and apply to most of the types of taxes levied by the State. Exhibit 2 provides a description of the different types of taxes levied by the State, the amount of state tax revenue generated by the taxes, and the number of tax expenditures we have identified related to each type of tax.

Exhibit 2 Colorado Tax Information

Tax	Description	Fiscal Year 2022 State Revenue Associated with Tax (Percent Total) ¹	Number of Tax Expenditures
Income ²	Colorado levies individual income tax on Colorado residents, including part-time residents, estates, and trusts at a rate of 4.4 percent of their Colorado taxable income. The same rate applies to the Colorado taxable income of corporations doing business in Colorado.	\$13,298,000,000 (67%)	102
Sales and Use	Colorado sales tax is required to be collected on the purchase price paid or charged on all retail sales and purchases of tangible personal property, unless specifically exempted by statute. Use tax is levied on retail purchases of tangible personal property that is stored, used, or consumed in Colorado when sales tax was not collected at the time of the purchase. The State’s sales and use tax rates are both 2.9 percent.	\$4,592,000,000 (23%)	78
Excise	Colorado levies excise taxes on a variety of goods and activities, including motor and aviation fuel, cigarettes and tobacco products, marijuana and marijuana products, liquor, gaming, nicotine products, and sports betting. In contrast to a sales tax, the excise tax is generally paid by the manufacturer or retailer, not the final consumer of the product. However, the retailer who ultimately sells the goods to the final consumer often builds the cost of the excise taxes into the purchase price of the goods. For excise taxes that are levied on activities such as gaming, the tax base is typically the gross, adjusted gross, or net proceeds from the activity. The state excise tax rate varies based on the type of good and the quantity purchased.	\$1,391,000,000 (7%)	39
Insurance Premium	Insurance companies operating in Colorado are levied a tax on the amount of the premiums they receive from policyholders. The insurance premium tax rate is typically 2 percent.	\$390,000,000 (2%)	18

Tax	Description	Fiscal Year 2022 State Revenue Associated with Tax (Percent Total) ¹	Number of Tax Expenditures
Severance	Severance taxes are imposed on the extraction of certain non-renewable natural resources, including coal, molybdenum and metallic minerals, and oil and gas. The tax base and rate vary depending on the type of resource extracted.	\$315,000,000 (2%)	14
Pari-Mutuel Racing	The Pari-Mutuel Racing tax is a tax levied on the gross receipts from wagers on horse and greyhound racing events. The tax rate varies based on the type of event and whether it is live or broadcast.	\$400,000 (<1%)	0
Estate	Estate taxes are levied on the transfer of an estate of a deceased person. However, based on the interaction between federal and state law, Colorado's estate tax was effectively repealed in 2005.	\$0 (0%)	0
TOTAL		\$19,986,400,000	251

Source: Office of the State Auditor analysis of Colorado Revised Statutes, and state revenue information provided by Legislative Council.

¹ Percentages may not total 100% due to rounding.

² Income revenue includes the Alternative Minimum Tax (AMT). AMT data is from Tax Year 2020, the most recent year available.

Local Government Impact

Because of the interplay between state and local sales and use tax laws, most state sales tax expenditure provisions also reduce the revenue collected by some local governments. Colorado has several types of local governments, including statutory cities and towns, home rule cities and towns, counties, and special districts. Statutory cities and towns are formed under the authority of state statutes, and their power is limited to that granted by state statutes, meaning that their sales and use tax laws must conform to the State's. Alternatively, the Colorado Constitution provides that cities and towns can adopt a home rule charter, which provides them with more authority to regulate local and municipal affairs independent from the State, including making their own local tax laws [Colorado Constitution Art. XX, Sect. 6].

Under Section 29-2-106, C.R.S., the Department of Revenue collects sales taxes for all non-home rule jurisdictions that have sales taxes and for some home rule jurisdictions that have elected to have the State collect sales taxes on their behalf. Under Section 29-2-102, C.R.S., all of these state-collected local jurisdictions may set their own sales tax rate, but must otherwise conform to the State's tax laws regarding sales and use taxation, and must apply all of the State's sales and use tax expenditures, with the exception of 20 sales tax exemptions specifically excluded by statute [Section 29-2-105, C.R.S.]. For these 20 exemptions, Section 29-2-105(1)(d), C.R.S., provides that state-collected local governments are not required to apply the state exemption and must specifically adopt the exemption in its local municipal code if it wants to apply it. As a result, with the exception of these 20 exemptions, the State's sales tax expenditures also apply to the local tax revenues for all

state-collected local governments. Because local governments with state-collected local taxes are required to substantially conform to the State’s sales and use tax laws, when possible, we estimated the revenue impact to local jurisdictions when evaluating sales tax expenditures that impact local governments’ tax revenue.

TABOR

The Colorado Constitution [Colo. Const. Art. X, Section 20] requires voter approval of all new taxes and tax increases in the State, as well as tax policy changes that result in increased state revenue. In addition, TABOR created a state spending cap, which is adjusted annually according to inflation and state population growth. If state revenue exceeds the spending cap, the State must refund the excess revenue or obtain voter approval to retain the revenue in excess of the cap.

Tax expenditures interact with TABOR in two ways. First, some tax expenditures are only available to taxpayers in years when the TABOR spending cap is reached. In effect, these tax expenditures lower the revenue collected by the State, which decreases the amount that must be refunded to taxpayers. Second, TABOR may restrict the General Assembly from repealing or modifying tax expenditures under some circumstances, although the law is unclear in this area. Specifically, TABOR requires voter approval of “tax policy changes directly resulting in a net tax revenue gain.” It is unclear how this provision may limit the General Assembly’s ability to change or repeal tax expenditures, when doing so results in a net revenue gain to the State. According to a 2018 Colorado Supreme Court ruling (*TABOR Foundation v. Regional Transportation District*), such changes are permissible when the underlying purpose of the change is not to increase tax revenue and the actual revenue increase is relatively small. However, the ruling does not indicate whether there are other circumstances under which such changes might also be permissible and whether changes to tax expenditures with the intent of increasing revenue would be considered as “*directly* [emphasis added] resulting in a net tax revenue gain.” Furthermore, the General Assembly has repealed tax expenditures since TABOR was passed without seeking voter approval, and such changes have not faced a legal challenge.

How are tax expenditures administered?

The Colorado Department of Revenue administers the State’s tax laws, including most tax expenditures, and collects all taxes, with the exception of the Insurance Premium Tax, which is administered by the Division of Insurance within the Department of Regulatory Agencies, as required by Section 10-3-209(1)(a), C.R.S. The Department of Revenue processes tax returns using GenTax, its tax processing and information system, and taxpayers submit most returns electronically. Typically, taxpayers claim tax expenditures through self-reporting. For some tax expenditures, taxpayers must provide the amount claimed when they file their state tax return forms, while for others, there is no reporting requirement or the Department of Revenue directs taxpayers to aggregate the expenditures with other figures, such as gross income or sales, before reporting. In

some cases, the Department of Revenue does not require taxpayers to submit documentation that supports a transaction's eligibility for a tax expenditure; however, it may require taxpayers to substantiate eligibility for tax expenditures as part of an audit.

In addition, some tax expenditures are administered by other state departments and agencies, in conjunction with the Department of Revenue. These tax expenditures typically require the other state departments and agencies to verify taxpayers' eligibility for a tax expenditure before taxpayers can claim it. For example, the Rural Jump-Start Tax Expenditures [Section 39-30.5-105, C.R.S.] are administered by the Governor's Office of Economic Development and International Trade (OEDIT) and the Economic Development Council and taxpayers must apply to and be approved by OEDIT before they can claim these tax expenditures. When tax expenditures are administered by an agency separate from the Department of Revenue, statute generally provides how the coordination between the agency and Department of Revenue should occur. For example, the other department or agency administering a tax expenditure may need to provide the Department of Revenue with a list of recipients of tax expenditures and the amount claimed or granted in order to verify that a taxpayer has properly claimed a tax expenditure. Similarly, in some instances, the administering agency may provide taxpayers with a certificate or other form of validation that they can attach to their tax returns.

Taxpayers are generally responsible for reporting income and transactions subject to tax, applying any available tax expenditures, and submitting payment. For income taxes, reporting requirements vary based on taxpayers' entity type for tax purposes. Specifically, taxpayers must file as follows:

Individuals. Taxpayers file as individuals when reporting their personal income and income tax liability using the Department of Revenue's Colorado Individual Income Tax Return (Form DR 0104). Business owners may include business income on their individual tax return if the business is formed as one of several "pass through entities." These include sole proprietorships, partnerships, limited liability companies, and S-corporations. For partnerships, certain limited liability companies, and S-corporations, the business must file a Colorado Partnership and S-Corporation Composite Nonresident Income Tax Return (Form DR 0106) to report their business income or loss for the year. However, these business entities are generally not liable for income tax, instead their profits or losses are apportioned among the owners, who then report the income or loss on the owners' Colorado income tax returns.

C-corporations. Businesses formed as C-corporations are responsible for reporting taxes separately from their owners and paying taxes based on their taxable income, which is calculated prior to distributing profits to owners (shareholders) in the form of dividends. C-corporations that are doing business in Colorado report their Colorado income and income tax liability using the Colorado C Corporation Income Tax Return (Form DR 0112). Dividend income received by C-corporation owners is generally taxable as income on the owners' respective income tax returns.

Businesses making applicable sales or transactions are typically responsible for reporting and remitting most of the State’s other taxes, such as sales, insurance premium, and excise taxes, and applying any available tax expenditures. For example, although sales taxes are paid by the consumer making the purchase, in most cases the retailer must collect the sales tax at the time of the purchase and remit it to the Department of Revenue using the Colorado Retail Sales Tax Return (Form DR 0100). Therefore, sales tax expenditures are usually applied by the retailer at the time of the sale and reported by the business when it submits its return.

How is each expenditure evaluated?

As required by statute [Section 39-21-305, C.R.S.], each tax expenditure evaluation must include the following types of information, which are outlined in Exhibit 3, along with a general description of the OSA’s evaluation approach.

Exhibit 3

Tax Expenditure Evaluation Requirements and OSA Approach to Evaluations

Required Elements	Number of Widgets
<p>A summary description of the purpose, intent, or goal of the tax expenditure</p> <p>The intended beneficiaries of the tax expenditure.</p>	<p>If the purpose and intended beneficiaries of the tax expenditure were directly stated in statute, we summarized this information in the report. If the statute did not state the intended purpose and/or beneficiaries, we inferred this information based on our review of the statute, legislative history, communications with stakeholders, tax expenditures in other states, and principles of good tax policy.</p>
<p>Whether the tax expenditure is accomplishing its purpose, intent, or goal</p> <p>An explanation of the performance measures used to determine the extent to which the tax expenditure is accomplishing its purpose, intent, or goal</p>	<p>If performance measures were provided in statute, we used those to determine whether the tax expenditure was accomplishing its purpose, intent, or goal. If no performance measures were provided in statute, we inferred performance measures based on the purpose and available data.</p>
<p>An explanation of the intended economic costs and benefits of the tax expenditure, with analyses to support the evaluation if they are available or reasonably possible</p>	<p>We conducted an economic analysis, including an estimate of the revenue impact, to the extent possible based on the available information.</p>
<p>A comparison of the tax expenditure to other similar tax expenditures in other states</p>	<p>We provided this information to the extent we could identify other states with similar tax expenditures.</p>
<p>Whether there are other tax expenditures, federal or state spending, or other...programs to the extent the information is readily available. . .that have the same or similar purpose...how those all are coordinated, and if coordination could be improved, or whether redundancies can be eliminated</p>	<p>We reviewed and reported on this information if it was readily available. For example, we reviewed statute for similar state and federal tax expenditures, searched state and federal agency websites, and performed research to identify potentially similar programs.</p>

Required Elements	Number of Widgets
If the evaluation of a particular tax expenditure is made difficult because of data constraints, any suggestions for changes in administration or law that would facilitate such data collection	We reported data constraints whenever they limited our ability to evaluate a tax expenditure or may have had an impact on the accuracy and reliability of our evaluation. In these instances, we reported the changes that would need to be made to collect the necessary data if such changes were under the control of a state agency.
To the extent it can be determined...(I) The extent to which the tax expenditure is a cost effective use of resources; (II) An analysis of the tax expenditure’s effect on competition and on business and stakeholder needs; (III) Whether there are any opportunities to improve the effectiveness of the tax expenditure in meeting its purpose, intent, or goal; and (IV) An analysis of the effect of the state tax policies connected to local taxing jurisdictions on the overall purpose, intent, or goal of the tax expenditure	We provided this information whenever such analyses were relevant to the tax expenditure and possible, based on the available information. Although our approach varied significantly for each tax expenditure, we searched for available information and considered whether it was possible to perform an analysis and draw conclusions in each of the areas listed.

Source: Colorado Revised Statutes and Office of the State Auditor tax expenditure evaluation methodology.

Principles of Good Tax Policy

In conducting our evaluations, we looked to sources such as the National Conference of State Legislatures, the Tax Policy Center, other states’ tax expenditure reviews, and Pew Charitable Trusts to gather information on best practices related to tax policy. We used this information to help infer the intent of tax expenditures when such intent was not provided in statute, and also to inform relevant policy considerations for the General Assembly related to each tax expenditure. Based on a review of these sources, we identified the following criteria that we used to evaluate tax expenditures when relevant:

- **Transparency.** Taxpayers and policymakers alike should be able to understand how the tax system works, including taxpayers’ expected tax liabilities.
- **Stability.** Taxation should result in a predictable amount of revenue for the government, and taxpayers should be able to predict in advance how much they can expect to pay in taxes as a result of any given decision or transaction.
- **Simplicity.** In order to assist taxpayers and policymakers in understanding the tax code, tax policy should be as simple as possible.
- **Ease of Administration.** The tax system should be administered with as little difficulty and cost as possible to taxpayers, tax professionals, financial intermediaries (such as banks), and the government.

- **Flexibility and Responsiveness to Competition.** Tax systems should be able to adapt to economic and technological changes that occur over time. Similarly, they should be responsive to the tax policies of other states and countries to help ensure sufficient competitiveness in a global market.

What limitations did the OSA face in evaluating tax expenditures?

In this report, the OSA strived to present as complete and accurate an assessment of each tax expenditure as possible. However, there are some limitations implicit in the evaluations due to a variety of factors, including lack of available data, the nature of tax expenditures themselves, and general principles of economics. We discuss these limitations below.

Limitations on Department of Revenue Information

We worked closely with the Department of Revenue to obtain information relevant to our tax expenditure evaluations and we appreciate the cooperation and assistance provided by the Department of Revenue throughout the review year. Despite working cooperatively with the OSA and making efforts to provide the data we requested, for many of the tax expenditures we reviewed, the Department of Revenue was not able to provide any information or was only able to provide limited information. The reasons for this are due to the inherent limitations of a self-reported tax system and limitations in the information the Department of Revenue collects and stores in GenTax, its tax processing and information system. The most common issues we found included the following:

Issues Inherent to a Self-Reported Tax System

- **Inaccurate Reporting by Taxpayers.** Even when the Department of Revenue was able to extract relevant data from GenTax, this data likely included some degree of inaccuracy because taxpayers may not properly complete forms. For example, a taxpayer may enter an exemption on the wrong line of a form or misunderstand the information requested. Although these errors may have no impact on the amount of tax the State collects, they can impact the reliability of the information for the purposes of evaluating a tax expenditure. These errors may be corrected if a taxpayer is audited by the Department of Revenue, but not all taxpayers are audited.
- **Timing of Returns.** Taxpayers may file amended returns, request extensions to return filing deadlines, have returns on hold while being reviewed or audited by the Department of Revenue, and at times, file returns past required deadlines. As a result, data relevant to tax expenditures for any tax year (the year for which a taxpayer is filing taxes) or other relevant filing period may fluctuate substantially based on when it is pulled and as updated return filings are received by the Department of Revenue. According to the Department of Revenue, it can take several years for

the relevant data to stabilize for some tax expenditures. As a result, information for tax expenditures for more recent tax years tends to be less reliable and it can be difficult to assess trends over time, especially for more recently enacted tax expenditures.

- **Timing of Tax Expenditures.** Because taxpayers can carry forward some tax expenditures across multiple years and they do not always claim the full value of the tax expenditures they have qualified for, it can be difficult to estimate the revenue impact of some tax expenditures or perform analysis of trends over time.

Limitations Due to the Information Collected and Stored by the Department of Revenue in GenTax

- **The Relevant tax expenditure information is not collected on a Department of Revenue form.** According to the Department of Revenue, it does not collect some information that would be relevant to evaluating a tax expenditure, if that information is not necessary for the Department to administer the tax system or if another department has more direct authority over the tax expenditure (e.g., The Office of Economic Development and International Trade works more closely with taxpayers claiming enterprise zone credits). Because requiring more information increases the filing costs and burden for taxpayers and the Department of Revenue's administrative costs, the Department typically attempts to collect only the information that is necessary for it to administer and enforce tax laws.
- **The Relevant tax expenditure information is collected on a Department of Revenue form, but is not captured by GenTax in a manner that allows it to be extracted.** This issue can take two forms: (1) a paper form is scanned and image data is stored, but the data is not captured in GenTax in a way that can be systematically retrieved without excessive manual labor; or (2) the form (whether filed online or on paper) data is captured, but GenTax would need to be programmed to pull comprehensive data. According to the Department of Revenue, it does not capture and program GenTax to pull all information reported by taxpayers on forms because it does not regularly use all of the information as part of its administration of taxes. In some cases, the information would only be useful if a taxpayer is audited, in which case, staff would be able to pull the relevant information for the relevant taxpayer. Pulling the information for all taxpayers who took a particular tax expenditure would not be possible.
- **The Relevant tax expenditure information is collected on a Department of Revenue form, but is aggregated with other information.** In some cases, multiple tax expenditures are aggregated by taxpayers prior to reporting and are then combined on a single line on a Department of Revenue form. According to the Department of Revenue, it allows certain items to be aggregated to simplify the reporting process and avoid taxpayer confusion due to an excessive number of lines on forms. In addition, the Department of Revenue may not need disaggregated information to administer the applicable tax expenditures.

Although we reported on these issues whenever they had an impact on our ability to evaluate a tax expenditure, we did not make recommendations to the Department of Revenue regarding whether it should make changes to its reporting requirements and/or perform the necessary programming in GenTax to make the information available for our reviews. We took a neutral approach on these issues because, in each case, the General Assembly and Department of Revenue would need to weigh the relative benefits of having more information available to review, compared to the additional costs to the Department of Revenue and additional burden and cost to taxpayers if they have to report additional information. According to the Department, another consideration is that additional reporting requirements may also increase the number of errors that taxpayers make and/or reduce their level of compliance with the requirements, which could have revenue impacts.

In order to provide a general estimate of the costs to make changes to the information it collects and captures in GenTax, in 2018 and 2021 the Department of Revenue provided the following information relevant to scenarios for addressing the most common data limitations we identified:

- **A new form would need to be created or an existing form changed.** The Department of Revenue would need to work with its vendor and the Department of Personnel & Administration, which is responsible for processing paper tax filings, to create the form. The cost is variable depending on how significant the change is. The costs for similar changes in recent years have ranged from about \$250 for a minor form change to as high as \$85,000 for a single form change with a more significant filing population or data capture requirements.
- **Additional data would need to be captured from paper forms.** The Department of Personnel & Administration prepares, scans, and performs data entry for paper tax forms for the Department of Revenue and bills for these services. The cost of capturing additional information from paper forms is highly variable based on the amount of data to be captured on each form and number of forms received and would be incurred on an ongoing basis. Collecting data on an entirely new form would be more expensive, for example, than adding a single line to an existing form. The Department of Personnel & Administration sets its annual rates based on actual activity in the prior year and projected activity in future years, and runs the risk of inadequate resourcing, overtime, and tax processing delays if the time for data entry is not forecasted correctly.
- **GenTax would need to be updated to house, map, and index data not currently captured.** This requires the Department of Revenue to work with its vendor to make the necessary programming changes and then perform testing to ensure that the changes operate properly. The costs for similar changes in recent years have ranged from about \$9,000 to add a single reporting line to an existing form, to about \$19,000 to create a new form, including programming and testing costs, though costs may be higher based on the specific changes.

It is important to note that depending on the tax expenditures and information needed, the Department of Revenue may incur the costs associated with one or all of the scenarios described.

Furthermore, these costs do not include Department of Revenue staff time to review taxpayer compliance with the new reporting requirements or additional programming that would be required to integrate controls, such as math verifications, to ensure accurate reporting. In addition, if a particular tax expenditure is reported across several forms, such as when it applies to several types of taxes or filers, the estimated costs would be multiplied for each change across forms. Added to these direct costs, the Department of Revenue would incur costs related to correcting errors on forms, answering questions, and working with the OSA to provide the necessary information.

Other Limitations to Our Analysis

In lieu of actual tax return data from the Department of Revenue, we often use other data sources to estimate the revenue impact of some tax expenditures. For example, the data sources may include the following categories:

1. **Federal Agencies**, such as the U.S. Census Bureau, the Internal Revenue Service, U.S. Energy Information Administration, and the U.S. Bureau of Economic Analysis.
2. **State Agencies**, such as Legislative Council, the Division of Insurance, the Secretary of State's Office, Office of Economic Development and International Trade, Department of Local Affairs, Department of Labor and Employment, and State Demographer's Office.
3. **Local Governments**, such as statutory and home rule cities and towns, counties, and special districts.
4. **Research Institutions**, such as peer-reviewed professional publications, university publications, and reports published by reputable private research institutions.
5. **Industry and Stakeholder Groups**, such as professional associations and other groups that are closely tied to industries relevant to a particular tax expenditure.
6. **Media Sources**, such as newspapers and trade publications.
7. **Taxpayers**, such as surveys and interviews with taxpayers who may benefit from the tax expenditures.

Use of third-party data can make the process of estimating the revenue impact of these tax expenditures significantly more difficult, in part, because this data may be less accurate than actual tax return data from the Department of Revenue and typically requires various adjustments in order to more accurately capture the effect of the tax expenditure in Colorado. In addition, the data from these sources is not always complete and the information provided is not always fully aligned with the information we needed for our evaluations.

How did the limitations to our analysis impact our conclusions?

Each tax expenditure presents its own challenges and limitations with respect to estimating the number of taxpayers who use the tax expenditure, its revenue impact to the State and local governments, and its impact to beneficiaries and the state's economy. For this reason, we have provided information in each evaluation regarding the sources of information we used, the assumptions we made to come to our conclusions, and the potential impact on our analyses. Therefore, readers should interpret the estimates provided in our evaluations as an indication of the magnitude of the impact as opposed to the exact impact of the given tax expenditure due to the limitations of the information sources.

Furthermore, the revenue impact estimates provided in our evaluations should not be taken as equivalent to the amount of revenue that would be gained if the given tax expenditure were to be repealed, because the cumulative effects of repealing the tax expenditure are difficult to predict in advance. There are several reasons for this:

- A general principle of economics is that individuals and businesses typically spend their money and other resources in ways that will yield the highest return. Therefore, repealing a tax expenditure, and thus increasing the tax assessed on a particular item or activity, may alter taxpayer behavior and change the associated tax revenue.
- Many tax expenditures overlap or interact with others, and we did not account for these interactions in our revenue impact estimates, in most cases. For example, different statutes may include exemptions for the same products, as in the case of charitable organizations that are exempt from paying sales tax on items they purchase for use in the course of their charitable activities and functions [Section 39-26-718(1)(a), C.R.S.]. Some of these eligible items that are purchased by charitable organizations may already be exempt from sales tax under other provisions, (e.g., a charitable organization may purchase food for home consumption, which is also exempt from taxation [Section 39-26-707(1)(e), C.R.S.]. Purchases of these items are included in the revenue impact estimate for the Sales to Charitable Organizations Exemption, but if this exemption were repealed, these items would still be exempt from sales tax under the Food for Home Consumption Exemption.

What were the results of the OSA's Evaluations?

Exhibit 4 provides a summary of the results of the OSA's 2023 tax expenditure evaluations. We completed evaluations for a total of 25 tax expenditures during the year.

Exhibit 4
Summary of the OSA’s 2023 Evaluation Results
(Sorted Alphabetically by Tax Type)

	Tax Expenditure Title	Tax Type	Year Enacted	Repeal/Expiration Date ¹	Estimated Revenue Impact ^{2,3}	Is it Meeting its Purpose?	Policy Considerations?
1	Sacramental Wine Exemption	Excise	1933	None	Minimal	No	Yes
2	Credit for Taxes Paid to Other States	Income	1937	None	\$262.6 million	Likely	No
3	Home Modification Tax Credit	Income	2019	January 1, 2029	\$76,400	To some extent	Yes
4	Military Retirement Benefits Deduction	Income	2018	January 1, 2029	\$2.5 million	To some extent	Yes
5	Rural & Frontier Healthcare Preceptor Credit	Income	2016	January 1, 2033	\$82,000	To a limited extent	Yes
6	Wildfire Mitigation Deduction	Income	2008	January 1, 2026	\$103,000	To a limited extent	Yes
7	Credit for Insolvency Assessments Paid	Insurance	1991	None	\$305,000	Yes	No
8	Structural Insurance Premium Tax Expenditures	Insurance	1913 – 1973	None	Could not determine	Yes	No
9	Agricultural Sales Tax Exemptions	Sales	1943 – 2019	None	\$268.2 million	Yes	No
10	Farm Close-Out Sales Tax Exemption	Sales	1945	None	Could not determine	Likely	No
11	Long-Term Lodging Exemption	Sales	1959	None	\$9.1 million	Yes	No
12	Newsprint & Printer’s Ink and Newspapers Exemptions	Sales	1943	None	\$3 million	Yes	No
13	Sales to Charitable Organizations Exemption	Sales	1935	None	Could not determine	Yes	No
14	Wholesales Sales Tax Exemption	Sales	1935	None	Could not determine	Yes	No

Source: Office of the State Auditor evaluations of Colorado’s tax expenditures.

¹ Repeal/expiration dates in this exhibit are current as of September 15, 2023. For evaluation reports included in this compilation report, expiration dates are current as of the date each report was originally published.

² The year the estimated revenue impact applies to varies by tax expenditure based on the availability of data. For more information, see the specific evaluation report.

³ Because tax expenditures often overlap, it is not possible to add the revenue impact from multiple expenditures to provide a total revenue impact.



Excise Tax-Related Expenditures



Sacramental Wine Exemption



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Colorado levies a total liquor excise tax of \$0.0833 per liter of wine sold, offered for sale, or used in the state. The Sacramental Wine Exemption exempts the sale and distribution of “sacramental wines sold and used for religious purposes” from the liquor excise tax. The exemption was likely intended to avoid taxing wine used by religious organizations for religious purposes.

We found that the exemption is likely not being applied to most of eligible sales of sacramental wine.

- Most religious organizations we contacted purchase wines used for religious purposes at liquor stores, but the exemption is not likely applied to these sales because liquor distributors and producers pay the excise tax long before the wine’s end use is known.
- The exemption is generally used when a non-liquor-licensed entity, such as a religious supply store or church, imports wine directly from an out-of-state producer.

Policy Considerations

We did not identify any new policy considerations for this exemption. In our previous evaluation of the exemption, we included a policy consideration that, in order to ensure that all religious groups are treated equally, the General Assembly could consider amending the exemption to accommodate sacramental wines’ different distribution paths, or alternatively, it could repeal the exemption.

Tax Type:	Liquor excise tax	Year Enacted:	1933
Expenditure Type:	Exemption	Repeal/Expiration date:	None
Statutory Citation:	Section 44-3-106(1), C.R.S.	Revenue Impact:	Minimal

Purpose given in statute or enacting legislation? **No**

Sacramental Wine Exemption

Background

Colorado levies a liquor excise tax of \$0.0733, plus an additional “wine development fee” of \$0.01, per liter of wine sold, offered for sale, or used in the state. In this report, we refer to both the excise tax and development fee collectively as the excise tax. The excise tax is remitted to the State by the wine’s producer or, if obtained from outside the state, the first licensee receiving the product in Colorado, usually a liquor wholesaler. Consumers rarely pay the excise tax directly, but the tax is generally passed on to them in the final price they pay.

The Sacramental Wine Exemption exempts the sale and distribution of “sacramental wines sold and used for religious purposes” from Colorado’s liquor excise tax. The exemption is one component of a broader exclusion for these wines from all provisions of the Colorado Liquor Code, such as the requirements that liquor sellers obtain a liquor license and file excise tax returns with the Department of Revenue (Department). No documentation or reporting to the Department is required to claim this exemption; a wine producer or importer may simply refrain from paying excise tax on the sacramental wine.

The exemption was likely intended to avoid taxing wine used by religious organizations for religious purposes. The National Prohibition Act (1919) outlawed the production and sale of most alcohol in the United States between 1920 and 1933. However, the Prohibition Act did not prohibit wine used for “sacramental purposes, or like religious rites,” which suggests that such wine was broadly viewed as distinct from wine used for personal consumption in the years leading up to and during Prohibition. Colorado lawmakers seem to have upheld this view with the 1933 legislation that allowed the sale of alcohol for personal consumption in the state and imposed a new liquor excise tax by exempting sacramental wines from the tax and from the new liquor regulations. The exemption has remained unchanged since 1935.

Technical Note:

Statute does not define either “sacramental wines” or “religious purposes,” so the intended extent of Colorado’s exemption is unclear. Wine is used in the practice of several religions. Many Christian traditions, such as Catholic and Episcopalian, use wine in the sacrament of the Eucharist, but other traditions, such as Baptist and Methodist, use grape juice instead. In the Jewish tradition, wine is used in rituals such as Passover, Kiddush, and Havdalah. Additionally, some varieties of wine are made in adherence to religious law, such as Kosher wine, but may be used for personal consumption by those adhering to a religiously-prescribed diet instead of being used in a formal religious ceremony.

At least 25 other states exempt sacramental wine from the state liquor excise tax, although some states administer their exemptions differently than Colorado. For example, unlike Colorado, North

Carolina requires religious organizations to seek a refund after first paying tax on sacramental wine, and Florida requires them to first obtain a permit before buying wine excluded from excise tax.

Performance Measures. In order to determine whether the exemption is meeting its purpose, we assessed the extent to which the exemption is applied to eligible sales of sacramental wines.

Evaluation Results

The exemption is likely not being applied to most eligible sales of sacramental wine.

Most religious organizations that we contacted appear to purchase wines used for religious purposes at liquor stores, but the exemption is not likely applied to these sales. We contacted representatives of Jewish synagogues, several Christian denominations, wine distributors, and religious supply retailers in Colorado to determine the circumstances under which the exemption is being applied. Both Jewish and Christian religious leaders reported using wine in their religious ceremonies, and most reported that they acquired such wine at local liquor stores. Liquor stores are supplied exclusively by licensed liquor distributors and producers, and none of the wine distributors told us that they apply the exemption or distribute any wines explicitly for religious use. The exemption would be difficult to apply to wine sold in liquor stores because liquor excise tax is generally paid long before the wine's end use is known, and the wine used for religious purposes may not be materially distinct from wine otherwise sold in the state. It is possible that a distributor could apply the exemption by excluding some of their stock from the liquor excise tax and ensuring that stock is sold only to religious organizations for religious use. However, it is unlikely that the savings provided by the exemption (about 6 cents per 750 ml bottle of wine) would merit this additional administrative burden. For example, one stakeholder reported that a typical church in their denomination might use 1 to 2 liters of wine per week, which equates to about \$4 to \$9 in excise tax per year.

The exemption is generally used when a non-liquor-licensed entity, such as a religious supply store or church, imports wine directly from an out-of-state producer. Although most representatives we spoke with reported that sales of sacramental wine occur at liquor stores, religious organizations may also obtain their wine through other retailers or directly from producers. For example, one religious leader reported purchasing wine directly from a producer outside of Colorado. We also identified two specialty religious supply retailers in the state, at least one of which sells sacramental wine purchased from an out-of-state producer. The exemption is being applied to these sales because the purchasers do not pay excise tax on the wine they import. The religious supply retailer noted that they sell wine only to religious organizations and do not sell any other alcohol, so they do not hold a liquor license or conform to other provisions of Colorado's liquor code.

The exemption’s revenue impact is likely minimal. We were unable to quantify the extent to which the exemption is used because neither retailers nor distributors are required to report these exempt sales to the Department. However, since the exemption appears to be used by relatively few organizations and Colorado’s liquor excise tax on wine is low, the exemption likely has a very small impact on state revenue. For example, exempting 100,000 bottles of wine from the tax would reduce state revenue by about \$6,250.

Policy Considerations

We did not identify any new policy considerations for this exemption. In our previous evaluation of the exemption, released in September 2018, we included a policy consideration that the General Assembly could consider amending the exemption to ensure that all religious groups are treated equally by either allowing for rebates for sacramental wine purchased through liquor stores and expanding the exemption to other types of alcohol that are also used in religious ceremonies or repealing the exemption. Although legislators introduced bills in 2020 and 2022 that would have removed the exemption from statute, the 2020 bill did not pass, and the provision that would have repealed the exemption was removed from the bill enacted in 2022.



Income Tax-Related Expenditures



Credit for Taxes Paid to Other States



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The Credit for Taxes Paid to Other States allows Colorado residents who earn income that is taxable in another state to claim an income tax credit in Colorado for the taxes they paid to the other state. We considered the purpose of the credit to be to prevent double taxation of income for Colorado residents who earn, and pay tax on, income from another state.

The credit is likely meeting its purpose because it is extensively used and avoids double taxation on income earned in other states; however, it may not eliminate double taxation in some distinct situations.

- According to stakeholders, the credit is commonly used among taxpayers who qualify; however, data does not exist on the total number of taxpayers that would qualify.
- The deduction generally prevents double taxation of income that was earned and taxed in another state.
- There may exist some distinct situations where a taxpayer does not qualify for the credit and is double taxed. For example, a taxpayer who is a resident of two or more states in the same year and earns income that is not tied to a location (e.g., dividends) or paid tax to the other state in a different year (e.g., taxes paid on retirement savings to another state in a previous year) would be double taxed on this income.

Policy Considerations

We did not identify any policy considerations for this tax credit.

Tax Type:	Income tax	Year Enacted:	1937
Expenditure Type:	Credit	Repeal/Expiration date:	None
Statutory Citation:	Section 39-22-108, C.R.S.	Revenue Impact (2020):	\$262.6 million

Purpose given in statute or enacting legislation? **No**

Credit for Taxes Paid to Other States

Background

The Credit for Taxes Paid to Other States allows Colorado residents who earn income that is taxable in another state to claim an income tax credit in Colorado for the taxes they paid to the other state. The credit is limited to income that is earned in a specific location (e.g., wages, rental income, royalties on oil and gas interests) and does not apply to income that is not earned in a specific location (e.g., dividends).

According to two representatives from the Colorado Society of Certified Public Accountants, taxpayers most commonly qualify for the credit because they paid taxes on business investment income in another state; royalty income earned on mineral assets owned in another state; income from property they rent or sold in another state; or because they worked in another state while maintaining full time residency in Colorado. Nonresidents are *not* able to claim the credit.

Resident taxpayers can claim the lesser of:

- The amount of tax paid to the other state(s), or
- A prorated share of the resident's income earned in the other state compared to the resident's Colorado taxable income.

Exhibit 1 shows an example of how the amount of the credit is calculated and applied against the taxpayer's income tax liability for a hypothetical taxpayer with a total of \$100,000 in taxable income, with \$90,000 earned in Colorado and \$10,000 earned in another state.

Technical Note

Colorado residents filing as individuals, fiduciaries, or estates are eligible for the credit.

Part-year residents are eligible for the credit for income they earned in another state while residing in Colorado. Income they earned while a resident of another state is not Colorado taxable income (i.e., if a taxpayer resides in one state and earns income and then moves to Colorado in that same year, the income they earned in the initial state is not taxable in Colorado).

Exhibit 1
Calculation of the Credit for Taxes Paid to Other States

1. Income earned in Colorado and Other State is combined to calculate Total Taxable Income.	Total Taxable Income: \$100,000
<p>A pie chart illustrating the composition of the total taxable income. The chart is divided into two segments: a large green segment representing Colorado Income at 90% (\$90,000) and a smaller blue segment representing Other State Income at 10% (\$10,000).</p>	
2. The Colorado Income Tax Rate is multiplied by Total Taxable Income to calculate Colorado Tax Liability.	Colorado Tax Liability: 4.4% x \$100,000 = \$4,400
3. Credit is calculated based on the proportion of income from the Other State x Colorado Tax Liability.	Credit Calculation: 10% x \$4,400 = \$440
4. Compare credit amount to the Actual Income Tax Paid to the Other State and claim the smaller amount.	<p>Taxpayer claims \$440 credit unless taxes paid to the other state are less* than \$440. Then taxpayer claims the actual amount paid.</p> <p><small>*Taxpayers will use the proportional calculation in states with a higher tax rate than Colorado's. In states with a lower tax rate than Colorado's, where final taxes paid to the other state are less than the proportional credit calculated, taxpayers will use their actual taxes paid.</small></p>
5. Taxpayer reduces their Colorado Tax Liability by the credit.	\$4,400 – \$440 = \$3,690

Source: Section 39-22-108, C.R.S., and Office of the State Auditor analysis of the calculation of the credit.

We considered the purpose of the credit to be to prevent double taxation of income for Colorado residents who earn, and pay tax on, income from another state. Preventing double taxation of the same income across different states aligns with the U. S. Constitution (Article I, Section 8, Clause 3), which gives Congress the power to regulate interstate commerce and, therefore, prohibits states from enacting laws that would discriminate against interstate commerce.

Statute does not provide performance measures to evaluate whether this credit is meeting its purpose; therefore, we developed the following performance measures to evaluate the credit:

Technical Note

The dormant Commerce Clause refers to the prohibition, implicit in the Commerce Clause [Article I, Section 8, Clause 3 of the U.S. Constitution], against states passing legislation that discriminates against or excessively burdens interstate commerce.

In 2015, the U.S. Supreme Court ruled that certain tax provisions that effectively double tax income earned outside the state is unconstitutional as the double taxation results in unfavorable treatment of interstate commerce. [Comptroller of the Treasury v. Wynne].

- To what extent is the credit being used?
- To what extent does the credit avoid double taxation of income for residents who earn income and pay taxes to other states?

Evaluation Results

The credit is likely meeting its purpose because it is extensively used and avoids double taxation on income earned in other states; however, it may not eliminate double taxation in some distinct situations.

In Tax Year 2020, the most recent year for which data is available, **about 72,900 individual and fiduciary Colorado taxpayer accounts claimed about \$262.6 million in credits.** Exhibit 2 shows the credit’s use among individual and fiduciary taxpayers in the 5 most recent years for which data is available—with individuals comprising almost all of the claims.

Exhibit 2
Total Number of Returns Claiming the Credit and Total Credits Claimed
Tax Years 2016 through 2020



Source: Office of the State Auditor analysis of Department of Revenue individual taxpayer data for Tax Years 2016 through 2020.

¹Fiduciaries are not reported in the data for Tax Years 2017 and 2019.

While the total number of credit claimants is around 71,000 and the credit appears to be widely used, data is not available on the exact number of taxpayers eligible for the credit, and therefore we cannot determine what portion of eligible taxpayers use the credit.

We did find that the portion of Colorado taxpayers claiming the credit has stayed relatively consistent between 2015 and 2020, the most recent year of data available, ranging from 2.3 to 2.4 percent of returns filed. Additionally, for individuals, higher income taxpayers more frequently claim the credit than lower income taxpayers. For example, 36 percent of full-year resident taxpayers with federal Adjusted Gross Incomes (AGI) of \$1,000,000 or more claimed the credit, compared to only about 1 percent of full-year resident taxpayers with an AGI between \$10,000 and \$49,999. Exhibit 3 provides more information on usage of the credit among individual tax returns in Tax Year 2019.

Exhibit 3
Credit Usage as a Percentage of Total Individual Tax Returns Filed¹, by AGI, for Tax Year 2019

Size of Federal AGI	Total Number of Returns Filed	Number of Returns Claimed Credit	Percentage of Returns Claimed Credit
\$ 10,000 to \$ 49,999	1,034,551	11,892	1%
\$ 50,000 to \$ 99,999	634,001	14,484	2%
\$ 100,000 to \$ 499,999	558,217	34,588	6%
\$ 500,000 to \$ 999,999	21,978	4,782	22%
\$ 1,000,000 and over	10,294	3,707	36%

Source: Office of the State Auditor analysis of Department of Revenue individual taxpayer data for Tax Year 2019.

¹ Department of Revenue Individual Statistics of Income data is for full-year residents only and does not include part-year residents or fiduciaries who may have filed returns or claimed the credit.

Further, it appears that eligible taxpayers are generally aware of the credit. Tax preparers in the state are well aware of the credit, so eligible taxpayers who use a tax preparer are very likely to take advantage of the credit. Additionally, the Department of Revenue (Department) announced a request for public input in April 2023 for rule revisions to improve clarity and provide additional guidance for calculating the credit and did not receive any comments regarding the operation of the credit, suggesting that stakeholders understand the eligibility requirements and the process to claim the credit. Also, for taxpayers who prepare their own taxes, Department forms, and third-party software accepted by the Department (e.g., TurboTax, TaxAct, H&R Block) provide clear notice of the availability of the credit and instructions for how to calculate and claim it. We also found that similar credits are available in every other state that that levies a

tax on wage income, therefore tax preparers who work in other states besides Colorado and taxpayers who earn income outside of the state might already be familiar with similar credits in other states.

Although the credit generally avoids double taxation on income earned in another state, it may not eliminate double taxation in some distinct situations. Because of the way the credit is structured—accounting for income and taxes paid on that income in another state—the credit generally avoids a taxpayer having to pay state income tax to multiple states on the same income. Additionally, the structure of the credit prevents taxpayers from receiving a credit in excess of the taxes they actually paid to states with lower tax rates because the credit is the lesser of the actual tax paid, or a prorated share of their income from other states in comparison to total Colorado income. For example, as shown in Exhibit 1, if a state has a lower tax rate than Colorado, the taxpayer would only receive a credit for the amount of tax they paid on that income to the other state, and would still owe Colorado income taxes on the difference of what would have been owed if the income was only taxed in Colorado.

However, there are some types of income and circumstances when the credit would not apply, so double taxation would not be prevented. The credit is limited to income that is earned in a specific location (e.g., wages, rental income, royalties on oil and gas interests) and does not apply to income that is *not* earned in a specific location (e.g., dividends). Therefore, if a taxpayer meets residency qualifications in Colorado and another state, and is considered a resident of both states, they would owe taxes to both states on the non-location specific income. Additionally, the credit is only available for taxes paid in the same year. For example, if a taxpayer paid taxes in another state on retirement contributions, and later took retirement distributions while residing in Colorado, the taxpayer would not be able to apply a credit against their income taxes for the retirement distribution. We did not have data to determine how often these situations occur, but the Department reported that these scenarios are generally infrequent.

Policy Considerations

We did not identify any policy considerations for this credit.

Home Modification Tax Credit



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The Home Modification Tax Credit provides up to a \$5,000 nonrefundable income tax credit to eligible taxpayers who modify an existing home to better accommodate a resident with an illness, impairment, or disability. Under statute, the credit’s purpose is “to make retrofitting a residence for health, safety, and welfare more affordable.”

The credit has made home modifications more affordable for those who have claimed it, but its impact has been limited because relatively few taxpayers have used it and many recipients are unable to claim the full credit amount.

- As of May 2022, the credits issued ranged between 4 percent and 100 percent of the total project cost. Over 40 percent of the credits issued covered more than half of the total project cost, and about one-third covered the entire project cost.
- Fewer taxpayers have been certified for the credit than expected. The fiscal note for the bill creating the credit anticipated an average of 260 credits would be issued each year compared to the average of 10 credits that the Department of Local Affairs has issued annually to date. It appears that a lack of awareness among potential beneficiaries has contributed to the credit’s limited use.
- Only half of the taxpayers who received the credit in 2019 had sufficient tax liability to claim their full credit amount after 3 years. Some of these taxpayers may not have sufficient tax liability to use the remaining credit amount within its 5-year carryforward period and will not receive the full financial benefit of the credit.

Policy Considerations

The General Assembly may want to:

- Review the cost effectiveness of the credit.
- Consider making the credit refundable to make home modifications more affordable for taxpayers with lower incomes.

Tax Type:	Income tax	First Year Available:	2019
Expenditure Type:	Credit	Repeal/Expiration date:	December 31, 2023
Statutory Citation:	Section 39-22-541, C.R.S.	Revenue Impact:	\$76,400 (through Tax Year 2021)

Purpose given in statute or enacting legislation? **Yes**

Home Modification Tax Credit

Background

The Home Modification Tax Credit provides up to a \$5,000 nonrefundable income tax credit to eligible taxpayers who modify an existing home to better accommodate a resident with an illness, impairment, or disability.

The amount of the credit is equal to the cost of the home modifications, up to \$5,000. The credit is not refundable, but it can be carried forward for up to 5 years, after which time any unused amount expires. To be eligible for the credit, taxpayers must have a taxable family income at or below \$153,000 in 2022, which is adjusted for inflation each year, and the home modifications must improve the ease of access to, safety of, and ability to age in place in the home for a taxpayer or their dependent who has an illness, impairment, or disability. The total amount of credits is capped at \$1 million each year, which is awarded on a first-come, first-served basis. The credit was first available in 2019 and can be claimed through Tax Year 2023. In 2019, House Bill 19-1135 modified statute to allow taxpayers to claim the credit if they have a dependent who has a disability that necessitates a home modification.

The Department of Local Affairs (DOLA) is responsible for determining eligibility and awarding credit certificates. As part of the eligibility determination, a healthcare or social service provider must determine that the taxpayer or their dependent have an illness, impairment, or disability that necessitates the home modification. In addition, DOLA requires the residence being modified to:

- Exist before the work begins (i.e., the work may not be completed during initial construction of the residence).
- Be the residence of the qualified individual and the person for whom the retrofit is required.
- Be located in Colorado.

DOLA requires the applicant to provide evidence of the completed project, such as pictures, and may conduct an inspection, after which it issues a certificate to the taxpayer. Taxpayers provide the certificate number to the Department of Revenue when they claim the credit on their income taxes.

We considered the intended beneficiaries to be individuals who require home modifications due to illness, impairment, or disability, including conditions associated with older age. According to the U.S. Census Bureau, in 2021, 8 percent of the population under age 65 in Colorado had a disability, and 15 percent of the State’s population was age 65 or older. These are two groups that are more likely to require home modifications in order to have improved functionality and physical access to the homes in which they reside. According to the U.S. Census Bureau, the average income of households in Colorado with individuals over age 65 was \$69,900 in 2021. Approximately 15 percent of individuals with disabilities in Colorado had income below the poverty level, which was about \$14,000 for an individual and \$28,000 for a family of four. Based upon the applications for the tax certificate, retrofitting a residence costs about \$15,700, on average, but ranged from about \$750 to more than \$130,000. Therefore, the cost of home modifications can constitute a significant portion of the income of some Coloradans who are eligible for the credit and it could be challenging for them to pay for home modifications without financial assistance.

There are six other states that offer a tax credit (Georgia, Maine, Missouri, Pennsylvania, and Virginia) or a deduction (Louisiana) similar to Colorado’s Home Modification Tax Credit. Other states’ credits or deductions range from \$500 to \$9,000.

According to statute [Section 39-22-541(1), C.R.S.], the purpose of the expenditure is “to make retrofitting a residence for health, welfare, and safety reasons more affordable.”

We developed the following performance measures to evaluate the credit:

- The extent to which the credit made retrofitting a residence for health, welfare, and safety reasons more affordable.
- The extent to which the credit has been used by eligible taxpayers.

Evaluation Results

The credit has made home modifications more affordable for those who have claimed it, but its impact has been limited because relatively few taxpayers have used it and many recipients are unable to claim the full credit amount.

Between April 2019 and May 2022, DOLA issued 39 credits worth a total of about \$179,000. The average credit issued was about \$4,600, with the credits often offsetting a significant amount of project costs. For example, the credits issued ranged between 4 percent and 100 percent of the total project cost. Over 40 percent of the issued credits covered more than half of the total project cost, and about one-third covered the entire project cost. However, fewer taxpayers have been certified for the credit than expected at the time it was established. Specifically, the fiscal note for House Bill 18-1267, which created the credit, anticipated an average of 260 credits would be issued each year compared to the average of 10 credits that DOLA issued annually from 2019 through 2021.

It appears that a lack of awareness among potential beneficiaries has contributed to the credit’s limited use. We contacted three groups that represent elderly and disabled Coloradans, and all three groups indicated that they were not actively promoting the credit and that awareness of the credit is probably low. DOLA also reported that, due to the COVID-19 pandemic, it has not conducted as much outreach to potential taxpayers in recent years and plans to conduct more in future years.

Additionally, **many credit recipients have not been able to claim the full value of the credit due to a lack of taxable income.** For the 15 taxpayers who received certification for a credit in 2019, we reviewed the recipients’ annual income tax filings for Tax Year 2019 (the first year they could have claimed the credit) through Tax Year 2021 (the latest year they could claim the credit at the time of our evaluation). We found that only about half of the taxpayers had sufficient tax liability to claim their full credit amount after 3 years. Of the taxpayers who had not used their credits after 3 years, most had taxable incomes below \$33,000, which would result in these taxpayers having, at most, \$1,450 in potential state tax liability that could be offset by the credit. Due to their relatively low taxable incomes and the credit not being refundable, some of these taxpayers may not have sufficient tax liability to use the remaining credit amounts within the 5-year carryforward period.

Because many taxpayers have not been able to claim the full value of the credit, its revenue impact to the State has been less than the value of the total credits awarded by DOLA. Based on our review of credit recipients’ income tax returns in the Department of Revenue’s tax filing system, GenTax, as of May 2022, taxpayers claimed a total of \$76,400, or about 60 percent of the total amount DOLA certified in 2019, 2020, and 2021. Exhibit 1 shows a breakdown of the total amounts certified and claimed each year.

Exhibit 1
Amount Certified, Taxpayers, and Credits Claimed
Calendar Years 2019 through 2021

Calendar Year	Credits Certified	Taxpayers Receiving	
		Certified Credits	Credits Claimed
2019	\$65,700	15	\$26,900
2020	\$18,600	4	\$18,400
2021	\$47,800	10	\$31,100
Total	\$132,100	29	\$76,400

Source: Office of the State Auditor analysis of DOLA certification data and credit certificate recipients’ income tax filings.

While taxpayers with lower incomes may not be able to use the full value of the credit, other state programs are available to help lower income Coloradoans with the cost of home modifications. The Department of Health Care Policy and Financing administers the Home Modification Benefit for Medicaid-eligible individuals enrolled in a Home and Community-Based Services (HCBS) waiver. If they are part of the HCBS Brain Injury; Spinal Cord Injury; Community Mental Health Supports; or Elderly, Blind and Disabled waiver, the lifetime maximum benefit is \$14,000. If they are part of the HCBS Children’s Extensive Support or Supported Living Services waiver, there is a \$10,000 limit over the 5-year life of the waiver. To be eligible for Medicaid, an adult must also have an income that is less than 133 percent of the Federal Poverty Level, which roughly equals a monthly income of \$1,500 per month or an annual income of \$18,000 for an individual. Therefore, the HCBS Home Modification Benefit may be able to cover lower income residents who might not be able to use the Home Modification Tax Credit due to their lower tax liability.

Policy Considerations

The General Assembly may want to review the cost effectiveness of the credit. Currently, due to its limited use, the administration of the credit does not appear to be cost effective. DOLA reports that it spends approximately \$55,000 per fiscal year administering the credit, which is about twice the financial benefit that taxpayers have received each year. According to DOLA, its administrative activities related to the credit include reviewing applications and awarding the credit, inspecting projects to ensure they meet the requirements for receiving the credit, and conducting outreach. However, if additional taxpayers claim the credit in future years due to increased outreach by DOLA or the credit being made refundable (see the policy consideration below), the administrative costs relative to the taxpayer benefit might decrease.

Additionally, to the extent that it encourages home modification projects that would not have otherwise occurred, the Home Modification Tax Credit may provide some additional financial benefits to the State. A 2017 academic study from New Zealand found that home modifications can reduce accidents that can result in additional medical care, such as emergency room visits, especially among those with a previous history of accidents. For individuals who are uninsured or participate in public insurance programs, the State might bear the cost of additional medical care. Therefore, helping taxpayers to pay for home modifications might reduce the State’s costs for these programs, although we could not quantify this impact.

The General Assembly may want to consider making the credit refundable to make home modifications more affordable for taxpayers with lower incomes. As discussed previously, we found that taxpayers with lower incomes often lack sufficient tax liability to receive the full value of the credit. For example, a taxpayer who is eligible for a \$5,000 credit would need to have a taxable income of roughly \$114,000 to have enough tax liability to claim the full amount in 1 year. Exhibit 2 shows the credit amount a taxpayer could potentially claim in 1 year at different income levels,

which is equivalent to their tax liability based on Colorado’s 4.4 percent income tax rate for Tax Year 2022 and assumes that they do not claim any other state tax credits.

Exhibit 2
Taxable Income Necessary to Claim a Tax Credit

Annual Taxable Income	Maximum Tax Credit that Could Be Claimed Per Year Based on Tax Liability
\$22,700	\$1,000
\$45,500	\$2,000
\$68,200	\$3,000
\$90,900	\$4,000
\$113,600	\$5,000

Source: Office of the State Auditor analysis of Colorado’s individual income taxes.

Although taxpayers can carry forward the credit for up to 5 years, receiving the benefit at a later time likely reduces the credit’s impact and some taxpayers may not be able to fully claim the credit. We found that about half of the taxpayers certified for a credit in Calendar Year 2019 had not fully claimed their credits after 3 years. Most of these taxpayers had taxable incomes under \$33,000 and lacked sufficient tax liability to claim the full amount available. If the General Assembly made the credit refundable, it would allow taxpayers to claim the full amount of the credit in the first year and ensure they receive the full value of the credit. We identified one state, Missouri, that has a refundable home modification credit. However, making the credit refundable would likely increase its revenue impact. For example, about 40 percent (\$55,700) of credits issued by DOLA were not claimed by taxpayers from 2019 through 2021; a significant portion of these unclaimed credits would likely have been claimed if the credit was refundable.

Military Retirement Benefits Deduction



OFFICE OF THE STATE AUDITOR

C O L O R A D O

Tax Expenditure Evaluation • January 2023 • 2023-TE2

This income tax deduction allows military retirees under age 55 to deduct \$15,000 of their military retirement pension income from state taxable income. Under statute, the deduction’s purpose is to “honor the sacrifice and service of veterans and to create an incentive for more veterans to make their post-military homes in the state.”

The deduction provides a gesture of honor to veterans for their service. However, it may not be a significant incentive for military retirees under age 55 to locate in Colorado.

- According to stakeholders, providing a tax benefit to military retirees, regardless of income level or financial need, serves as a way to honor and thank military retirees for their service.
- The deduction provides a relatively small financial incentive (about \$660) compared to other states, many of which do not tax any military retirement pension income.
- Location decisions are complex, and tax incentives are just one of many decision factors for military retirees. Colorado’s quality of life and strong job market are more likely to attract military retirees than the tax deduction. Additionally, the tax benefit the deduction provides is likely too small to overcome other financial considerations for veterans when selecting a place of residence, such as the overall cost of living in the state and employment opportunities.

Policy Considerations

If the deduction is renewed, the General Assembly may want to consider periodically increasing the amount of the deduction to account for pension cost of living increases and/or inflation.

Tax Type:	Income tax	Year Enacted:	2018
Expenditure Type:	Deduction	Repeal/Expiration date:	1/1/2024
Statutory Citation:	Section 39-22-104(4)(y), C.R.S.	Revenue Impact (2020):	\$2.5 million

Purpose given in statute or enacting legislation? **Yes**

Military Retirement Benefits Income Tax Deduction

Background

The **Military Retirement Benefits Deduction** allows military retirees under age 55 to deduct \$15,000 of their military pension income from their Colorado taxable income.

House Bill 18-1060 established the deduction, phasing in the deduction amount between Tax Years 2019 and 2022 and setting it to expire January 1, 2024. For Tax Year 2023, the \$15,000 annual deduction amount provides a maximum reduction in tax liability of about \$660. However, because the deduction can only be applied to military pension payments during the same tax year, taxpayers with less military pension income than the deduction maximum cannot claim the full benefit. Exhibit 1 shows the maximum tax savings for beneficiaries each year assuming that taxpayers had sufficient tax liability and military retirement income to be able to deduct the maximum amount.

Exhibit 1
Maximum Deduction Benefit to Taxpayers for Tax Years 2019 through 2023

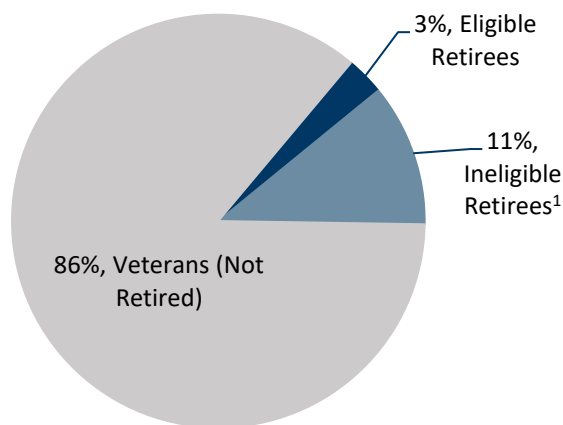
Tax Year	Deduction Limit	Tax Rate	Maximum Tax Savings
2019	\$4,500	4.5%	\$203
2020	\$7,500	4.55%	\$341
2021	\$10,000	4.55%	\$455
2022	\$15,000	4.4%	\$660
2023	\$15,000	4.4%	\$660

Source: Section 39-22-104(4)(y), C.R.S., and Office of the State Auditor analysis of the monetary benefit of the deduction based on state tax rates for Tax Years 2019 through 2023.

Beneficiaries of the deduction are individuals younger than 55 who are paid a *regular* military retirement pension that is subject to federal tax (i.e., non-disabled active duty service members).

According to the U.S. Department of Defense, Office of the Actuary, as of September 2020, there were about 10,000 military retirees in Colorado who were under age 55 and receiving a federally taxable pension. The total population eligible for the deduction represents a relatively small segment of military veterans in the state. According to the Department of Military and Veterans Affairs, as of 2020, roughly 394,000 veterans resided in Colorado; of those, about 54,000 were military retirees. Exhibit 2 shows that only 3 percent of the veteran population in Colorado is eligible for the deduction.

Exhibit 2
Proportion of the State’s Veteran Population Who Are Military Retirees Eligible for the Deduction, Federal Fiscal Year 2020



Source: Office of the State Auditor analysis of Department of Military and Veterans Affairs data and U.S. Department of Defense, Office of the Actuary data for reports published December 2020.

¹Ineligible Retirees include individuals whose benefits are not taxed at the federal level (i.e., those with a combat-related disability or those receiving benefits through the Veterans Administration) or those who are 55 years or older and not eligible for this deduction.

Technical Note:
IRS Publication 525 defines types of income and states that both military pension benefits for retirees with a combat-related disability, as well as Veterans Administration (VA) benefits are not considered taxable income. Because these benefits are not federally taxed, they are also automatically excluded from Colorado taxable income.

In general, to qualify for military retirement pay, service members must serve a minimum of 20 years. Active duty service members are those who work for the military full-time, whereas reserve members (Reservists) are part-time military service members that generally hold a civilian job at the same time. Because Reservists serve part-time, they must also be at least 60 years old to receive retirement benefits, making them ineligible for the deduction. These taxpayers would instead be eligible for the State’s broader Pension and Annuity Deduction.

The General Assembly established the deduction to “honor the sacrifice and service of veterans and to create an incentive for more veterans to make their post-military homes in the state.”

According to testimony during the committee hearings for House Bill 18-1060, this deduction was intended to both honor veterans and economically benefit Colorado by incentivizing veterans who are still of working age to locate in the state. Statute does not provide performance measures to evaluate whether this deduction is meeting its purpose; therefore, we developed the following performance measures to evaluate the deduction:

- To what extent is the deduction being used?
- Does the deduction provide veterans a gesture of honor for their service?
- To what extent does the deduction act as an incentive for military retirees to locate in Colorado?

To assess these performance measures we:

- Reviewed data from the Department of Revenue; the U.S. Department of Defense, Office of the Actuary; and the Department of Military and Veterans Affairs on the veteran population, the military retiree population, and the taxpayers claiming the deduction.
- Interviewed stakeholders about their awareness of the deduction and its value to veterans.
- Reviewed similar tax benefits provided in other states, and researched the relative importance of an income tax incentive for military retirees.
- Analyzed changes in Colorado’s military retiree population compared to national, and other state trends.

Evaluation Results

The deduction is partially meeting its purpose because it provides a benefit specific to veterans that honors them for their service. However, it likely does not have a significant impact on the number of military retirees under age 55 who locate in Colorado.

According to Department of Revenue data **for Tax Year 2020, about 7,700 taxpayers claimed the deduction, and it had a revenue impact to the State of about \$2.5 million.** More than 90 percent of the taxpayers claimed the full \$7,500 deduction available that year, which provided a tax benefit of about \$340 to each taxpayer. Based on our review of U.S. Department of Defense, Office of the Actuary data, the 7,700 taxpayers claiming the deduction represent about 77 percent of the

10,000 potentially eligible military retirees. It is possible that some eligible military retirees did not claim the deduction, either due to a lack of awareness or because they did not have taxable income.

Stakeholders reported that a tax benefit for military retirees serves as a way to honor and thank veterans for their service. We spoke with representatives from two veterans' advocacy organizations and both reported that a tax benefit specific to veterans honors their service. One organization reported that other similar income tax deductions, such as the Pension and Annuity Deduction, do not honor veterans in the same way because they are also available to non-military retirees. Stakeholders also reported that the deduction was particularly effective at honoring veterans' service because it was available to all retired veterans under age 55 regardless of income level. In contrast, they reported that many veterans' benefits through the Veterans Administration are based on financial need, income level, and disability rating. While these benefits are important in financially and socially assisting veterans, the Military Retirement Benefits Deduction serves as a way to value all retired military service members separate from programs that may provide specific groups with government assistance.

The deduction probably does not provide a significant incentive for military retirees to locate in Colorado because most states have larger exemptions, the financial benefit is relatively small, and tax incentives are just one of many factors military retirees take into account when deciding where to live. Almost every state offers a tax incentive for military retirees either by allowing a deduction or credit specific to military pensions, or through a more general pension deduction available to all taxpayers. Colorado is one of 33 states and the District of Columbia (DC) that has an income tax deduction specifically for military retirees. Most of these states allow military retirees to deduct their full pension from income taxes, but eight states (including Colorado) and DC only offer a partial benefit. Another 16 states provide either a broader pension deduction to other types of retirees, or have no income tax and, therefore, military retirement income is also not taxed. Only one state, California, fully taxes military retirement income. Exhibit 3 shows the different states and their treatment of military retirement income.

Exhibit 3 State Tax Treatment of Military Retirement Benefits

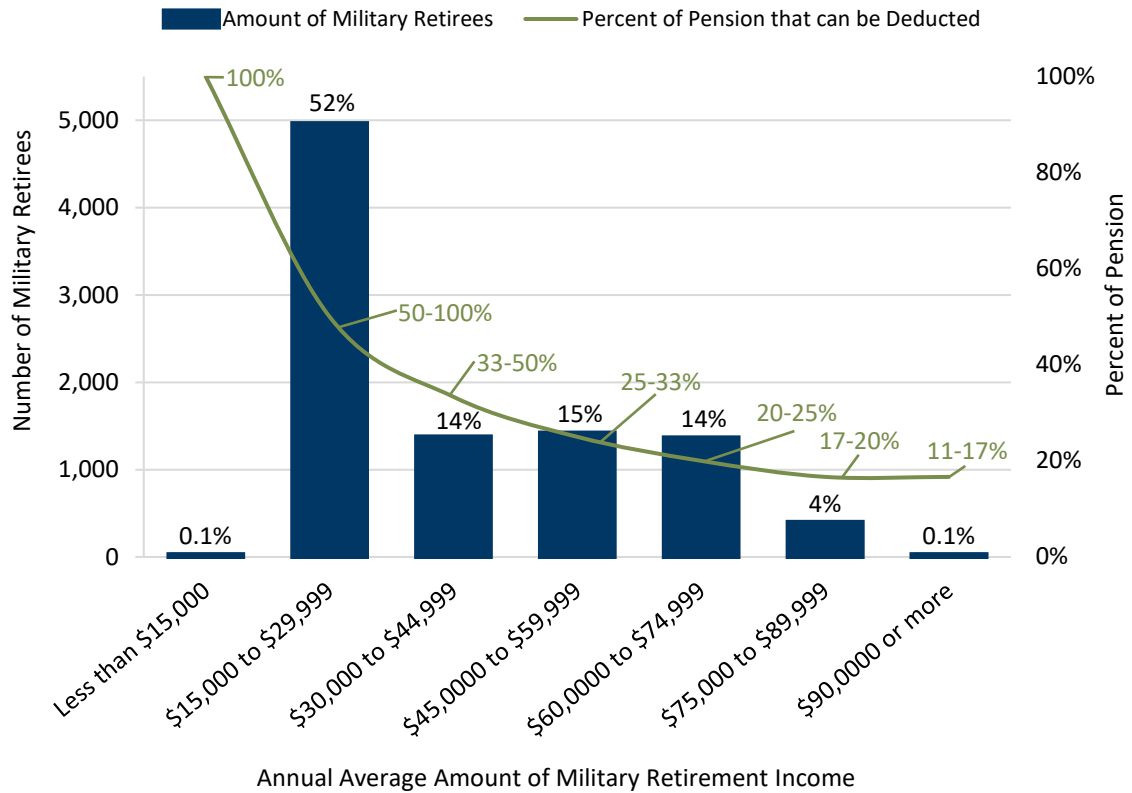


Source: Office of the State Auditor analysis of the U.S. Army military benefits website and state statutes and regulations, as of 2022.

In addition to offering a smaller benefit than most states, the deduction’s \$660 maximum tax benefit may provide a relatively small reduction in overall tax liability for many military retirees. According to data from the U.S. Department of Defense, Office of the Actuary, in 2022, less than 1 percent of military retirees under age 55 in Colorado had pensions below the \$15,000 statutory limit. Therefore, almost every retiree would still have to pay income tax on a portion of their retirement income. As shown in Exhibit 4, about half the military retirees in Colorado had between \$15,000 and \$29,999 in military retirement income and would be able to deduct between 50 and 100 percent of their retirement income. A little less than half of the retirees had at least \$30,000 in military retirement income and would be able to deduct between 11 and 50 percent of their retirement income.

Exhibit 4

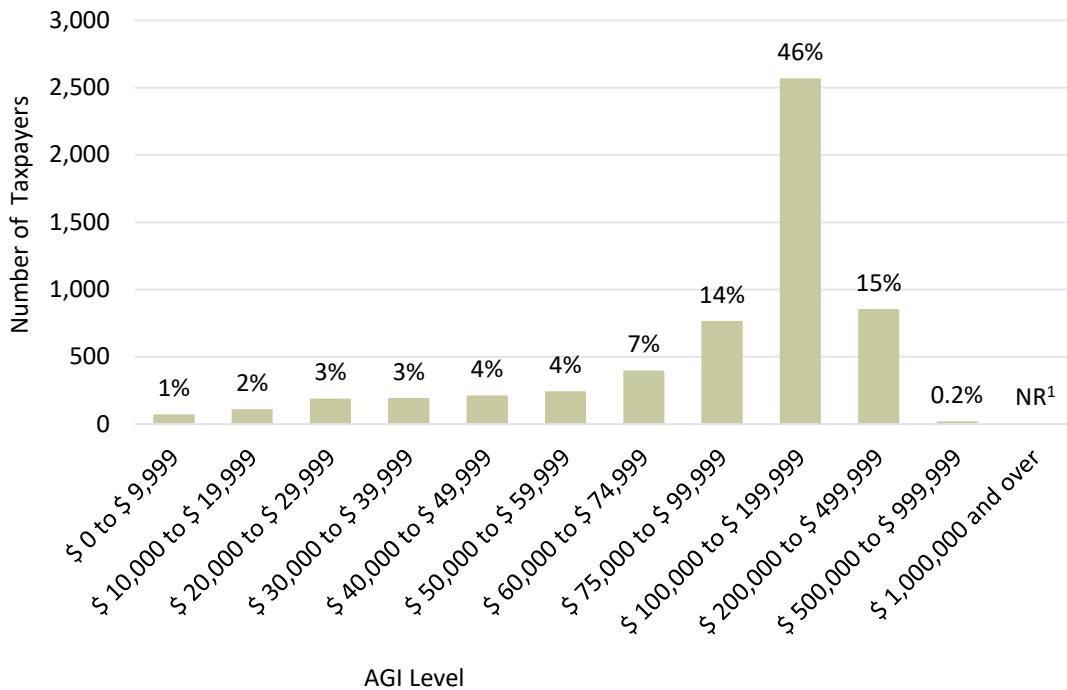
Amount of Military Retirees by Amount of Annual Pension Income and the Percentage of Retiree Pension Income That Can Be Deducted, Federal Fiscal Year 2022



Source: Office of the State Auditor analysis of U.S. Department of Defense, Office of the Actuary data on average annual pension payments for Non-Disabled Military Retirees between the ages of 38 and 54 for Federal Fiscal Year 2022.

In addition to military retirement benefits, many military retirees under age 55 have additional income as they (and/or their spouse) obtain post-military employment. For example, according to Department of Revenue data for Tax Year 2019, nearly half of the retirees who claimed the deduction had between \$100,000 and \$200,000 in Adjusted Gross Income (AGI); therefore, the tax savings provided by the deduction is a relatively small portion of their overall tax burden. For example, a taxpayer with \$100,000 in taxable income would owe approximately \$4,400 in state income taxes (at a 4.4 percent income tax rate). The deduction (valued at \$660 in this scenario) would only save them about 15 percent on their total state income taxes, which might not be enough to significantly influence their retirement location decision. Exhibit 5 shows the AGI levels of Colorado taxpayers who claimed the deduction in Tax Year 2019.

Exhibit 5
Amount of Taxpayers Claiming the Deduction by AGI Level,
Tax Year 2019



Source: Office of the State Auditor analysis of the Department of Revenue Statistics of Income, number of Full Year Resident tax returns claiming the Military Retirement deduction, by AGI, for Tax Year 2019.

¹ Figure is not reportable per Department of Revenue taxpayer confidentiality requirements.

While tax incentives are often included in evaluations of “best places to live” provided by veterans organizations and the U.S. Department of Defense, other factors likely influence retirement location decisions more than tax benefits. Research suggests that military retirees evaluate retirement destination largely based on family proximity, lifestyle amenities, previous experiences in the state, economic opportunity, the cost of living, the quality of government services, and access to military communities and resources. For example, a 2017 study from the University of Utah, Kem C. Gardner Policy Institute, *Analysis of Military Retirees in Utah: Impacts, Demographics and Tax Policy* found that tax policy is one of the less important factors known to influence place of residence decisions and that state income tax benefits were unlikely to result in an increase in military retirees locating in Utah. Additionally, according to a 2018 study on military retiree location decisions for retirees of all ages, conducted by the Fermanian Business and Economic Institute, the most important indicators of the number of military retirees residing in each state were:

- The size of Active Duty installations
- Home prices

- Share of military retiree pay taxed
- Average temperature
- Job opportunities
- Unemployment rate

In general, states with no income tax, such as Florida and Texas, tend to have the highest number of military retiree populations.

We also spoke with stakeholders about the importance of a tax incentive for military retirees when they are deciding where to retire. Overall, stakeholders reported that having some type of favorable tax policy can be important because it is something veterans will look at when making a decision, but may be very important for retirees age 55 and over who are at the end of their working career and are living on a fixed income. Retirees under age 55 are generally looking for post-military employment and are more likely to factor in the economic conditions of a state, including job opportunities, cost of living, and the overall quality of life (e.g., schools, support services for veterans, weather). For example, stakeholders reported that a military retiree under age 55 is more likely to locate in an area where they or their spouse receive a job opportunity, and to consider lifestyle amenities such as access to the outdoors and weather, rather than prioritizing state income tax policies. Additionally, stakeholders reported that high housing costs may deter retirees from locating in Colorado despite the state tax benefit.

While we could not quantify the impact of the deduction on Colorado's military retirement population, there do not appear to have been significant changes in this population since the deduction's enactment compared to overall national trends. According to data from the U.S. Department of Defense, Office of the Actuary, since the deduction was enacted in 2018, Colorado has remained as the state with the ninth-largest military retiree population under age 55. In the last 5 years, Colorado has seen a slight decrease (6.5 percent decline) in its military retiree population under age 55. However, this is similar to the overall nationwide decrease and may also be the result of military retirees aging out of the eligible population and fewer service members retiring rather than leaving the state.

Although there are economic benefits associated with military retirees choosing to live in a location, including additional spending and property and income taxes, studies on military retiree tax deductions as an incentive generally do not show that deductions incentivize military retirees to move to a state. Therefore, revenue losses from the deduction may not be offset through increased additional economic activity. However, we did not have sufficient data for employment, spending, and location decisions from beneficiaries to develop an estimate of these economic benefits.

Policy Considerations

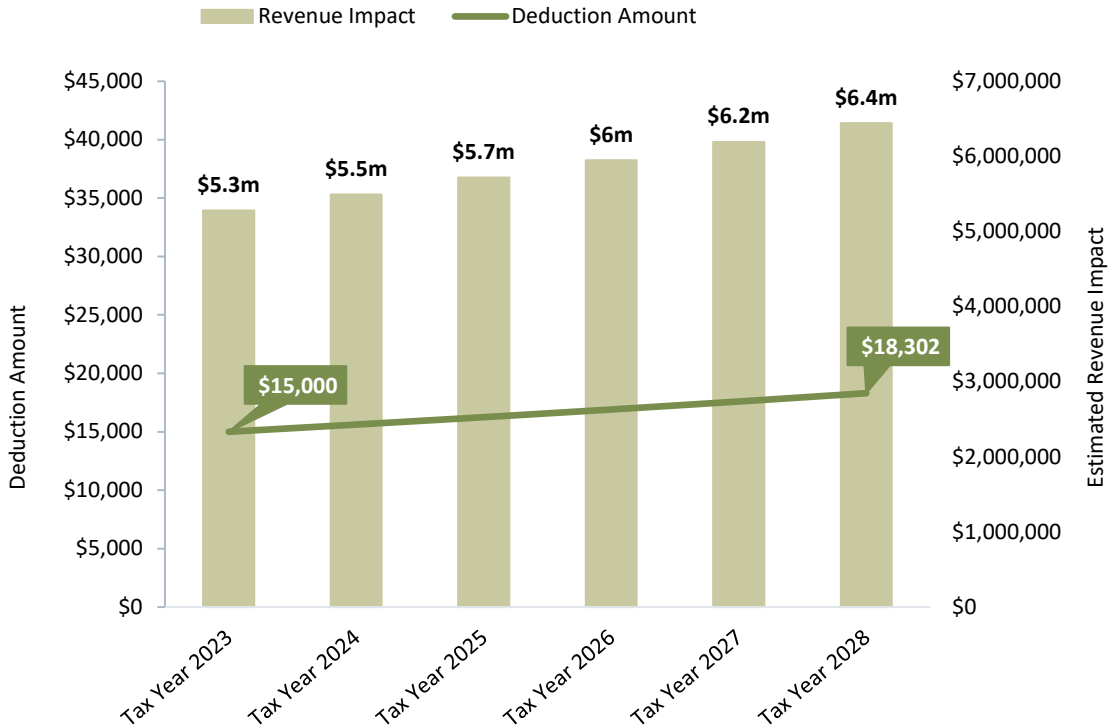
If the General Assembly chooses to renew the deduction, it may want to consider adjusting the deduction limit to account for cost of living increases and inflation.

The deduction is not scheduled to increase in order to account for inflation or adjustments to military pension payments, which could reduce the relative benefit it provides in future years. Military retirement pay is adjusted annually, as a Cost of Living Adjustment (COLA). While the actual adjustment for individual retirees varies based on several factors, including their enlistment and retirement dates and the type of pension plan they are enrolled in, the U.S. Department of Defense, Defense Finance and Accounting Service reports an annual average COLA each year, ranging from 1.3 percent for 2021 up to 8.7 percent for 2023. Because of these adjustments, the General Assembly may want to consider increasing the amount of the deduction annually to maintain the value of the deduction commensurate with the value of the military retirement income. Additionally, because the COLAs will vary among individual retirees, the General Assembly may want to consider using an inflation index, such as the U.S. Bureau of Labor Statistics' Consumer Price Index or the U.S. Department of Defense, Defense Finance and Accounting Service's annual average COLA adjustment, for simplicity.

Adjusting the deduction for inflation would increase the cost of the deduction to the State and may make the deduction more difficult to administer for the Department of Revenue since the amount would change each year and certain changes require updates to tax forms and programming in its tax processing and information system, GenTax. Exhibit 6 shows a hypothetical example of the estimated revenue impact of increasing the current deduction amount of \$15,000 by 4.06 percent annually (the U.S. Department of Defense, Defense Finance and Accounting Service's reported average COLAs between 2019 and 2023). Overall, assuming about 8,000 taxpayers per year are able to claim the full deduction, this increase would result in the revenue impact increasing from about \$5.3 million in Tax Year 2024 to about \$6.4 million in Tax Year 2028.

Exhibit 6

Hypothetical Revenue Impact of Renewing the Deduction at \$15,000 and Annually Adjusting the Deduction by 4.06 Percent¹, Assuming 8,000² Military Retirees Can Claim the Maximum Deduction



Source: Office of the State Auditor analysis of the U.S. Department of Defense, Office of the Actuary data using the 5-year average Cost of Living Adjustment and Department of Revenue-reported amounts of beneficiaries claiming the deduction in Tax Year 2020.

¹ Annual average Cost of Living Adjustment of 4.06 percent is based on the U.S. Department of Defense, Defense Finance and Accounting Service’s most recent average Cost of Living Adjustment increases in pensions and does not project future adjustments which could differ from the 5-year average.

²8,000 military retirees is an assumed amount based the U.S. Department of Defense, Office of the Actuary data for Federal Fiscal Year 2022 of 9,400 military retirees under age 55 in Colorado and Department of Revenue data for Tax Year 2020 showing that about 7,700 taxpayers used the deduction in Tax Year 2020. Not all eligible military retirees claim the deduction or the full amount of the deduction; therefore, we adjusted the eligible beneficiaries amount downward.



Rural & Frontier Healthcare Preceptor Credit



OFFICE OF THE STATE AUDITOR

C O L O R A D O

Tax Expenditure Evaluation • August 2023 • 2023-TE11

The Rural & Frontier Healthcare Preceptor Credit (Preceptor Credit) provides a \$1,000 nonrefundable income tax credit to certain licensed healthcare providers in rural and frontier areas of Colorado who provide a mentoring program of personalized instruction, training, and supervision to eligible health professional students; these providers in this context are referred to as “preceptors”. According to statute, the purpose of the credit is “to encourage preceptors to offer professional instruction, training, and supervision to students matriculating at Colorado institutions of higher education who are seeking careers as primary health-care providers in rural and frontier areas of the state.” Additionally, statute provides that the general purposes of the credit are to “induce certain designated behavior by taxpayers...” and “provide tax relief to preceptors in rural and frontier areas of the state...”

The Credit has not encouraged a substantial number of providers in rural and frontier areas of the state to become preceptors. The tax relief provided by the credit varies depending on how many extra hours per day a provider spends training students and the type of provider the preceptor is. Stakeholders reported that there continues to be a shortage of preceptors in rural and frontier areas of the state.

- In 2021, 2 percent of physicians, 1 percent of dentists, 1 percent of advanced practice nurses, and 6 percent of physician assistants in rural and frontier areas precepted students and claimed the credit.
- The credit provides a lower hourly benefit than providers’ regular hourly wages, and the amount becomes comparatively much less once the preceptor provides more than 1 hour of teaching per day outside of the regular workday.

Policy Considerations

The General Assembly could consider allowing taxpayers to claim more than one credit per year if they precept more students. In addition, the General Assembly could consider whether additional oversight regarding certification of the Preceptor Credit form is necessary, since we identified several taxpayers who claimed the credit but who did not meet the requirements to qualify.

Tax Type:	Income tax	Year Enacted:	2016
Expenditure Type:	Credit	Repeal/Expiration Date:	January 1, 2033
Statutory Citation:	Section 39-22-538, C.R.S.	Revenue Impact (2021):	\$82,065

Purpose given in statute or enacting legislation? **Yes**

Rural & Frontier Healthcare Preceptor Credit

Background

The Rural & Frontier Healthcare Preceptor Credit (Preceptor Credit) provides a \$1,000 nonrefundable income tax credit to certain licensed healthcare providers in rural and frontier areas of Colorado who provide a mentoring program of personalized instruction, training, and supervision to eligible health professional students. These providers in this context are referred to as “preceptors.”

To qualify for the credit, the healthcare provider (see technical note) cannot accept compensation for the mentoring program, and it must last at least 4 working weeks, or 20 business days. The weeks or days do not need to be consecutive, and the healthcare provider can precept multiple students to satisfy the duration requirement. The precepted student(s) must be enrolled at an accredited Colorado institution of higher education and seeking a degree or certification in a primary healthcare field. Many degree and certification programs require students to participate in clinical rotations, referred to as “preceptorships.”

Additionally, each healthcare provider may only earn one tax credit per year regardless of how many students they precept, and only up to 300 total preceptors are allowed to claim the credit in a single income tax year. The credit is not refundable, but it can be carried forward for up to 5 years, after which time any unused amount expires.

Statute [Section 39-22-538(2)(b) and (g), C.R.S.] defines a rural area as “an area listed as eligible for rural health funding by the federal office of rural health policy” and a frontier area as “a county in the state that has a population density of six or fewer individuals per one square mile.” Colorado has 52 counties that are entirely rural and/or frontier areas, and parts of eight additional counties are also considered to be rural. These are shown in Exhibit 1.

Technical Note:

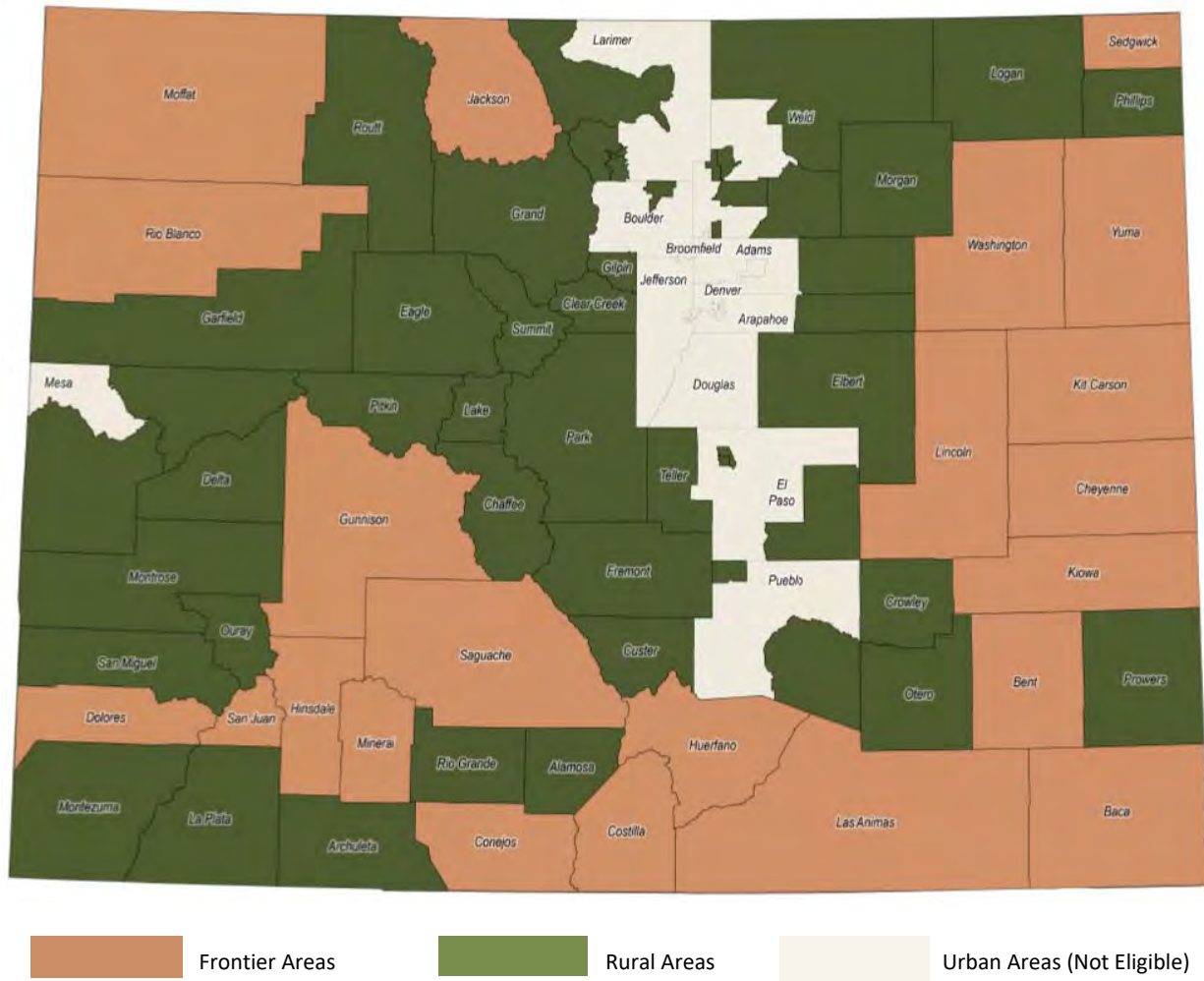
Beginning August 10, 2022, the following types of healthcare providers are eligible for the credit as long as they are licensed in their primary healthcare field and working in an outpatient clinical setting:

- Medical doctor
- Doctor of osteopathic medicine
- Physician assistant
- Advanced practice nurse
- Registered nurse
- Doctor of dental surgery or medicine
- Registered dental hygienist
- Pharmacist
- Licensed clinical or counseling psychologist
- Licensed professional counselor
- Licensed clinical social worker
- Licensed marriage and family therapist
- Psychiatric nurse specialist
- Licensed or certified addiction counselor

Prior to August 10, 2022, only medical doctors, doctors of osteopathic medicine, physician assistants, advanced practice nurses and doctors of dental medicine or surgery were eligible for the credit.

Exhibit 1

Map of Rural and Frontier Areas of Colorado for the Preceptor Credit



Source: Map created by Grant Smith - GIS Analyst, Governor's Office of Information Technology (OIT) based on Office of the State Auditor analysis of U.S. Census Bureau and Federal Office of Rural Health Policy data and Section 39-22-538(2)(b) and (g), C.R.S., requirements.

The credit was first available in 2017 and was initially scheduled to expire at the end of Tax Year 2019. Legislation in 2019 (House Bill 19-1088) and 2022 (House Bill 22-1005) extended the credit's expiration date, and it is currently set to expire at the end of 2032. House Bill 22-1005 also made other significant changes to the credit, including expanding it to include additional eligible healthcare provider and student types; increasing the annual cap on the number of preceptors allowed to claim the credit from 200 to 300; and broadening the definition of a rural area so that it encompasses rural areas in otherwise urban counties. The change in the definition of "rural" for purposes of the credit now allows certain census tracts in Adams, Arapahoe, Boulder, El Paso, Larimer, Mesa, Pueblo, and Weld Counties to be included in the credit's eligibility area; the eligible areas may change periodically in the future when the Federal Office of Rural Health Policy updates its eligibility for funding based on new census tract data.

To claim the credit, the preceptor must receive a certification indicating that they satisfied all requirements to receive the credit from the institution where they teach or from the regional area health education center (AHEC) office with jurisdiction over the area where the preceptorship took place. They must provide the certification to the Department of Revenue (Department) before they can claim the credit. They must also attach the certification to their income tax return to claim the credit.

According to statute [Section 39-22-538(1)(d)(I)(A) and (B), C.R.S.], the general purposes of the credit are to “induce certain designated behavior by taxpayers...” and “provide tax relief to preceptors in rural and frontier areas of the state...” **Additionally, statute [Section 39-22-538(1)(d)(II), C.R.S.] provides that the specific legislative purpose of the credit is “to encourage preceptors to offer professional instruction, training, and supervision to students matriculating at Colorado institutions of higher education who are seeking careers as primary health-care providers in rural and frontier areas of the state.”**

We considered the beneficiaries of the credit to be primary healthcare preceptors in rural and frontier communities who do not receive compensation for providing structured mentoring programs to students enrolled in eligible programs at Colorado higher education institutions. Since 2017, there have been 246 preceptors approved to claim the credit. In addition to the preceptors, students enrolled in eligible programs at Colorado higher education institutions may also benefit from the credit because it may increase the number of preceptors and amount of preceptorships available to them in rural areas of the state. Finally, rural and frontier communities in Colorado may also indirectly benefit from the Preceptor Credit. According to the Colorado Rural Health Center, all rural and frontier counties in the state are experiencing shortages of healthcare professionals, which is compounded by difficulty in recruiting and retaining providers in these areas. Academic studies have demonstrated that students who participate in rural clinical rotations during school are more likely to practice in rural communities after they graduate. Therefore, in the long term, rural and frontier communities could potentially benefit from an increase in healthcare providers practicing in those communities.

We developed the following performance measures to evaluate the credit:

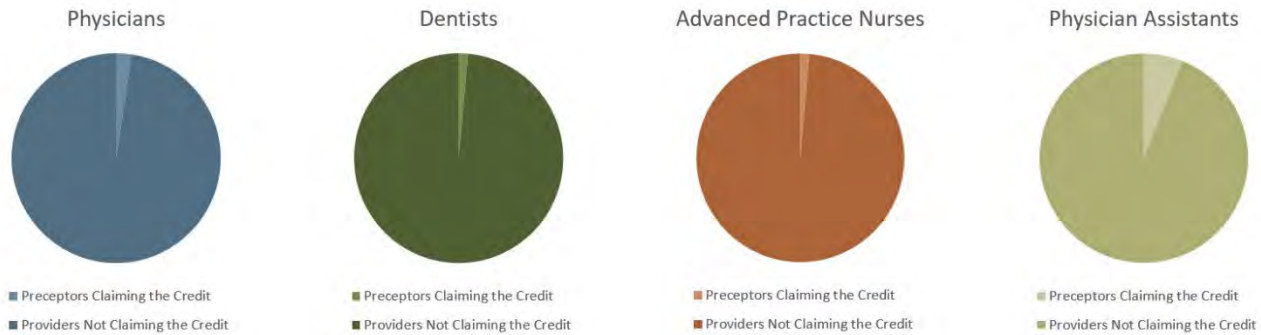
- The extent to which the credit encouraged eligible preceptors to offer preceptorships to students enrolled at Colorado institutions of higher education.
- The extent to which the credit provides tax relief to preceptors in rural and frontier areas of the state.

Evaluation Results

The Preceptor Credit has not encouraged a substantial number of providers in rural and frontier areas of the state to become preceptors. In Tax Year 2021, the Department approved 92 taxpayers to claim the credit and 83 subsequently claimed the credit on their 2021 income tax returns. We compared credit claims, by provider type, to data from the Colorado Health Systems Directory, which

is maintained by the Primary Care Office at the Colorado Department of Public Health and Environment (CDPHE), and shows the number of physicians, advanced practice nurses, physician assistants, and dentists practicing in rural and frontier areas of the state. As Exhibit 2 shows, 2 percent of physicians, 1 percent of dentists, 1 percent of advanced practice nurses, and 6 percent of physician assistants in rural and frontier areas precepted students and claimed the credit in 2021.

Exhibit 2
Eligible Healthcare Providers by Type Compared to Preceptors Who Claimed the Credit in 2021¹

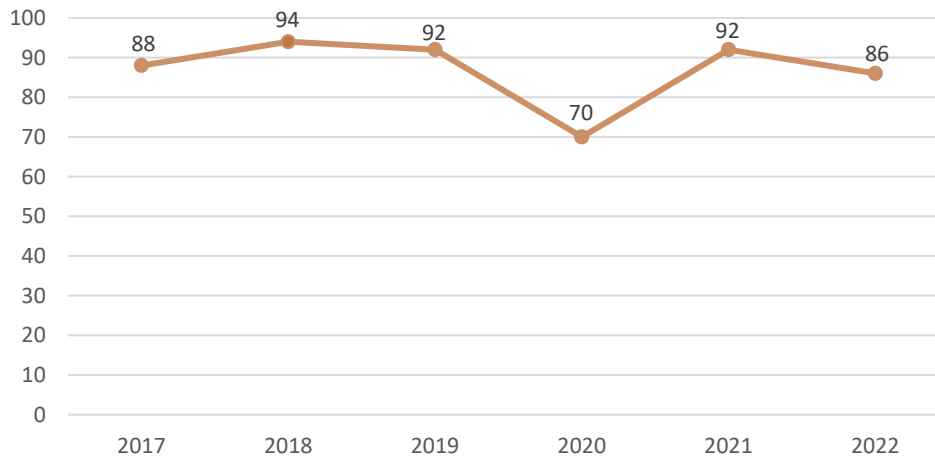


Source: Office of the State Auditor analysis of 2021 Rural & Frontier Health Care Preceptor Forms (Form DR 0366) for taxpayers who were approved for the credit and claimed it in 2021 and data from the Colorado Health Systems Directory, maintained by the Primary Care Office at CDPHE.

¹The Colorado Health Systems Directory may include some providers who are not eligible for the credit. Specifically, the Colorado Health Systems Directory data includes all providers (e.g., specialists, emergency medical providers) and the credit is only available for providers who are in primary care. This analysis excludes nine taxpayers who were approved for the credit but did not claim it and six taxpayers who were approved and claimed the credit but were in located in areas that were not considered rural in 2021.

When we conducted an evaluation of this credit in 2019, stakeholders reported that there was a shortage of rural preceptors. In 2020, the COVID-19 pandemic made it difficult for students to get clinical rotations in rural areas due to restrictions from the schools, the clinical rotation sites, or both, which made the preceptor shortage worse during the pandemic. However, according to Department data showing credit certificates submitted and approved, the number of preceptors approved for the credit returned to pre-pandemic levels by 2021, although it slightly dropped in 2022 as shown in Exhibit 3.

Exhibit 3 Preceptors Approved to Claim the Credit, 2017-2022



Source: Office of the State Auditor analysis of Department of Revenue data.

The extent of the tax relief provided by the credit varies considerably depending on how many extra hours per day a provider spends training students and the type of provider the preceptor is.

In order to be approved for the Preceptor Credit, the preceptor must provide at least 4 weeks of instruction, training, and/or supervision. However, preceptors typically spend 1-2 extra hours per day outside of their normal schedule training students based on information provided by preceptors to the Colorado Rural Health Center. Therefore, we calculated the hourly benefit that the Preceptor Credit provides based on how many extra hours a preceptor spends instructing students outside of their normal schedule. If a preceptor spends 20 extra hours during the preceptorship instructing students (i.e., an average of 1 extra hour per day), that equates to a \$50 per hour monetary benefit from the credit. If a preceptor spends 40 extra hours instructing students (i.e., an average of 2 extra hours per day), that equates to a \$25 per hour monetary benefit. For each additional hour spent, the hourly monetary benefit provided by the Preceptor Credit decreases. We did not have data on the actual number of hours preceptors spent each day instructing students since that information is not required to be included on the certification form. We compared the hourly benefit to data from the U.S. Bureau of Labor Statistics on the average hourly wage for several eligible provider types in Colorado, specifically:

- Family Physicians: \$105
- Physician Assistants: \$59
- Nurse Practitioners: \$56
- Dentists: \$74

For all of these providers, the Preceptor Credit provides a lower hourly benefit than the provider's regular hourly wage, and the amount becomes comparatively much less once the preceptor provides more than 1 hour of teaching per day outside of the regular workday. When we spoke with representatives from programs at Colorado institutions of higher education, they stated that the amount of time a provider

spends with students often depends on how advanced the students are in their studies. Students who are early in their studies often take more time to train and they may see fewer patients, whereas students who are more advanced in their studies can be more helpful and take less time to train.

Additionally, the actual tax liability decrease from the credit varied by provider type. In Tax Year 2021, on average, the credit reduced the tax liability for advance practice nurses by 18 percent, physician assistants by 16 percent, dentists by 14 percent, and physicians (MDs and DOs) by 8 percent. Therefore, all taxpayers experienced some tax relief but the extent varied among taxpayers.

Overall healthcare workforce shortages in rural areas may be contributing to preceptor shortages, particularly for students at Colorado institutions of higher education. Fewer healthcare providers in rural areas means there are fewer potential preceptors, and the remaining providers may have a higher patient load, which makes it difficult for them to also provide clinical training for students. We spoke with representatives from public college and university programs in Colorado and they reported that there continues to be a shortage of preceptors in rural areas of the state and that there is heavy competition for preceptors. They stated that the Preceptor Credit helps them compete with private programs that pay their preceptors and out-of-state programs that send students to Colorado, and that they use the credit as a tool to help them attract and retain preceptors. The representatives from the programs generally think the credit is helpful for attracting and retaining preceptors, but said it is difficult to determine how much the credit incentivizes providers to become preceptors relative to other factors such as university library access and the altruistic desire to provide a benefit to the public and their profession by providing training opportunities for students. Some providers may also be eligible for continuing medical education credits, which are required for many types of healthcare providers, for precepting students. In addition, some newly eligible fields might not be aware of the credit. We spoke with representatives in programs at three Colorado institutions of higher education that have students who could be precepted by newly eligible preceptors, and all three were not aware of the credit prior to us contacting them. However, they stated that now that they are aware of the credit, they plan to use it to try to attract and retain preceptors for their students.

Policy Considerations

The General Assembly could consider allowing taxpayers to claim more than one credit per year if they precept more students, which could help address the shortage of preceptors. Some program representatives mentioned that preceptors will take enough students to earn the credit but then not accept additional students and that allowing preceptors to claim more than one credit per year may encourage them to precept additional students. There are five other states that offer a tax credit similar to Colorado's credit—Georgia, Hawaii, Maryland, Missouri, and South Carolina. All other states allow preceptors to claim more than one credit if they participate in multiple preceptorships during the year; other states' credit amounts range from \$375 to \$1,000 per preceptorship.

Allowing preceptors to claim additional credits could provide an incentive for them to precept additional students, but would increase the credit’s revenue impact to the State. For example, if each of the 86 preceptors who were certified for the credit in 2022 (see Exhibit 4) were allowed to claim two credits for precepting more students, the total credits certified would be 172 with a cost of \$172,000 for the year—assuming all preceptors claimed all of the credits they were certified for that year. The number of credits issued and annual cost would still be less than the 300 credits with a corresponding cost of \$300,000 per year anticipated by the fiscal note for House Bill 22-1005 when the General Assembly increased the number of preceptors who could claim the credit from 200 to 300 per year and expanded the list of eligible professions. As shown in Exhibit 4, over the past 6 years the number of taxpayers who claimed the credit has ranged from a low of 66 preceptors in 2020 to a high of 92 in 2019, while the revenue impact of the Preceptor Credit has ranged from a low of \$65,211 in 2020 to a high of \$90,392 in 2019.

Exhibit 4
Revenue Impact of the Preceptor Credit, 2017–2022

Year	Revenue Impact	Number of Claimants
2017	\$76,000	76
2018	\$87,781	89
2019	\$90,392	92
2020	\$65,211	66
2021	\$82,065 ²	83 ¹
2022	\$86,000 ³	86 ¹

Source: Office of the State Auditor analysis of Department of Revenue data.

¹ Number of claimants for 2021 is based on examination of individual tax returns in GenTax, the State’s accounting system, and does not account for claimants that may have carried forward amounts from prior years. Number of claimants for 2022 is based on approvals and does not reflect actual claims on the tax returns.

² 2021 revenue impact is based on examination of individual tax returns in GenTax. This would not account for amounts carried forward from prior years.

³ \$86,000 would be the revenue impact if all approved preceptors claim the credit on their tax return. The revenue impact will be less if not all approved preceptors claim the credit on their tax returns. This amount also does not take into consideration amounts carried forward from prior years.

The General Assembly could consider whether additional oversight regarding certification of the Preceptor Credit form is necessary. When we evaluated the credit in 2019, we found that in Tax Year 2017, 12 of the 74 taxpayers (16 percent) who claimed the credit had not met the requirements to qualify for it. Some of the reasons that these taxpayers were not eligible included precepting students who were not enrolled at Colorado institutions of higher education, precepting medical residents, precepting ineligible student types, or the preceptors were not located in rural or frontier areas. For this evaluation, we examined the forms for taxpayers who claimed the credit in Tax Year 2021. Of the 83 taxpayers who claimed the credit on their Tax Year 2021 tax returns, there were potential issues with the forms for 10 taxpayers (12 percent); in several of these cases, it was unclear who certified the taxpayers’ forms because signatures were illegible and no other information about the certifiers was provided. We also noted the following additional issues with the 10 forms (some forms had more than one issue):

- Six taxpayers were not in eligible rural areas
- One taxpayer did not precept eligible students for enough days
- One form did not include any information on the students precepted (e.g., no student names or dates listed)
- Two taxpayers only listed students who were not enrolled at Colorado schools, which are not eligible
- Two taxpayers only listed medical residents, which are not eligible
- One taxpayer precepted a non-eligible student type

The Department reported that it has not disallowed or recaptured the credits claimed by the taxpayers we identified in 2017 because “eligibility for the health care preceptor credit is determined and certified by an outside agency with expertise in the field.” According to statute [Section 39-22-538(4), C.R.S.], the agencies permitted to certify credits are “the institution for which the taxpayer teaches, whether it is an institution of higher education or a hospital, clinic, or other medical facility, or...the particular regional office of the A[rea] H[ealth] E[ducation] C[enter] program with jurisdiction over the area in which the preceptor’s medical practice is located.” The Department further reported, “the Department does not, as part of its review, re-evaluate the decisions of the certifying institution, agency, or entity on the certification. In this sense, the Department did not ‘approve’ these credits. Rather, we confirmed that they were claimed consistent with the certification provided pursuant to [S]ection 39-22-538(4), C.R.S. (which simply states that ‘[t]o qualify for the credit provided by this section, the taxpayer shall submit a certification form with each income tax return’). The Department lacks the expertise, resources, and statutory authority to audit and change the eligibility determinations of the agency charged with certification.”

The issues we found with the certification forms, such as the preceptor not being in a rural area, not precepting students for enough hours, or precepting ineligible students did not require medical expertise to identify. However, if the General Assembly would like an organization with medical expertise and familiarity with the preceptorship program to review and approve the certification forms, it could consider giving this authority to the Colorado AHEC Program Office, which is located on the University of Colorado Anschutz Medical Campus. Colorado’s six regional AHEC offices connect the Colorado AHEC Program Office with medically underserved communities in the state. Statute [Section 39-22-538(4), C.R.S.] already gives the AHEC Program the authority to charge preceptors a fee to certify their credits.

Since statute delegates certification authority to outside agencies and does not provide explicit authority to or require a state entity to review the eligibility determinations, there is a potential lack of accountability when someone improperly certifies the form (i.e., the preceptor did not meet the requirements but a certifier signs it anyway) or an ineligible person certifies the form. For example, we found that in several instances the taxpayers certified (signed) their own forms, but they were allowed to claim the credits. If the General Assembly amends statute to allow preceptors to earn and claim more than one Preceptor Credit per year (see section on Policy Considerations), and taxpayers are allowed to improperly claim credits, it is possible the cap of 300 credits per year could be reached and some eligible preceptors might not receive a credit when credits are being improperly claimed.

In our previous evaluation of the Preceptor Credit, we included an additional policy consideration that the General Assembly could clarify whether the minimum duration of a preceptorship, which is 4 weeks, should be counted as 28 days (i.e., 4 calendar weeks) or 20 days (i.e., 4 business weeks). In 2019, with House Bill 19-1088, the General Assembly clarified that preceptorships should be a minimum of 4 working weeks, or 20 business days, to qualify for the credit. Therefore, our previous policy consideration has been addressed.



Wildfire Mitigation Deduction

Tax Expenditure Evaluation • February 2023 • 2023-TE4

The Wildfire Mitigation Deduction allows owners of private property in a wildland-urban interface area to claim an income tax deduction for 50 percent of costs of performing wildfire mitigation, up to a maximum deduction of \$2,500 per tax year. Per statute [Section 39-22-104(4)(n.5)(III)(D), C.R.S.], wildfire mitigation is defined as “the creation of a defensible space around structures; the establishment of fuel breaks; the thinning of woody vegetation for the primary purpose of reducing risk to structures from wildland fire; or the secondary treatment of woody fuels by lopping and scattering...or prescribed burning...”.

We found that the Wildfire Mitigation Deduction provides landowners with a relatively small financial benefit relative to the cost of wildfire mitigation.

- At most, the deduction provides a \$110 tax benefit and covers 2.2 percent of project costs. If a landowner spends more than \$5,000 on mitigation, the tax benefit would represent an even smaller percentage of the total cost of the mitigation work. For example, if a landowner spends \$10,000 on mitigation work, the tax benefit would only cover 1.1 percent of the cost.
- Other tax credits and programs in the state provide a greater financial benefit to landowners who perform wildfire mitigation activities. For example, the Wildfire Hazard Mitigation Expenses Credit, starting in Tax Year 2023, provides an income tax credit worth up to \$625 to landowners who perform wildfire mitigation on their property and have a federal taxable income at or below \$120,000.

Policy Consideration

The General Assembly may want to review the eligibility requirements for the Wildfire Mitigation Deduction and the Wildfire Hazard Mitigation Credit to determine if they are consistent with legislative intent.

Tax Type:	Income	Year Enacted:	2008
Expenditure Type:	Deduction	Repeal/Expiration date:	2026
Statutory Citation:	Section 39-22-104(4)(n.5), C.R.S.	Revenue Impact (2020):	\$103,000
Purpose given in statute or enacting legislation? No			

Wildfire Mitigation Deduction

Background

The Wildfire Mitigation Deduction allows owners of private property in a wildland-urban interface area to claim an income tax deduction for 50 percent of costs of performing wildfire mitigation, up to a maximum deduction of \$2,500 per tax year.

The deduction is available to individuals, estates, and trusts that are landowners, but not C-corporations, partnerships, S-corporations, or similar entities that own private land as an entity. The deduction was created in 2008, and the only substantial change that has occurred was with House Bill 16-1286, which increased the percentage of landowners' costs eligible for the deduction from 50 to 100 percent for Tax Years 2017 through 2019. The total deduction was still capped at \$2,500 per landowner during this time. In addition, House Bill 22-1007, passed in 2022, extended the deduction's expiration date to January 1, 2026.

Per statute [Section 39-22104(4)(n.5)(III)(D), C.R.S.], wildfire mitigation is defined as “the creation of a defensible space around structures; the establishment of fuel breaks; the thinning of woody vegetation for the primary purpose of reducing risk to structures from wildland fire; or the secondary treatment of woody fuels by lopping and scattering... or prescribed burning...” The Colorado State Forest Service (CSFS) and the Division of Fire Prevention and Control, within the Department of Public Safety, establish the minimum standards for the mitigation measures in order for the costs to be eligible for the deduction. Qualifying costs include paying contractors or purchasing equipment to perform wildfire mitigation measures. Costs that are not eligible include a landowner's own time and labor, donations in-kind, grants, and inspection or certification fees. Taxpayers claim the deduction when they file their income tax return and submit receipts for eligible expenses.

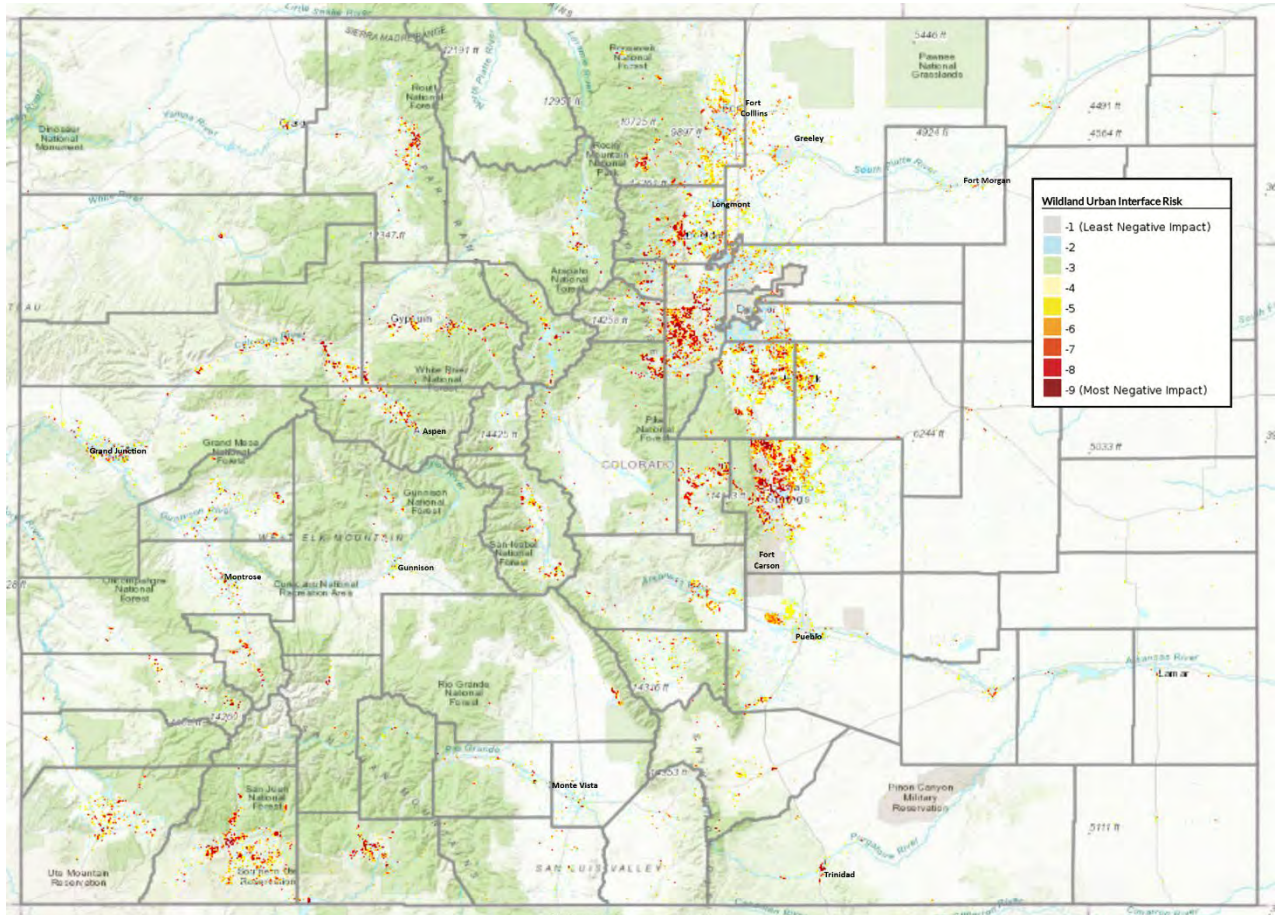
Technical Note

Department of Revenue guidance for the deduction defines wildland-urban interface area as a place where structures or other development are built close to natural terrain and flammable vegetation with high potential for wildland fires.

Wildfires cause significant damage to property in Colorado each year. For example, according to the Rocky Mountain Insurance Information Association, the 2021 Marshall Fire in Boulder County resulted in insurance claims of over \$2 billion, with more than 1,200 properties lost or damaged. Wildfire mitigation can reduce damage to property when a wildfire occurs nearby. According to the National Fire Protection Association, removing flammable materials, such as vegetation and mulch, from the perimeter of a home and thinning trees can significantly decrease wildfire damage or destruction.

CSFS estimated that about 11 percent of Colorado’s population lived in an area with high risk of wildfire in 2017, and, due to population growth and development in rural areas, the number of properties in wildland-urban interface areas is projected to increase. Exhibit 1 shows the high risk wildland-urban interface areas for wildfires.

Exhibit 1 High Risk Wildland-Urban Interface Areas



Source: Colorado State Forest Service’s Wildfire Risk Public Viewer.

We considered the purpose of the deduction to be to provide financial support for taxpayers who incur wildfire mitigation costs. House Bill 22-1007, which extended the deduction and created a new Wildfire Hazard Mitigation Expenses Credit for taxpayers who incur wildfire mitigation costs, stated that the purpose of the credit is “...to reimburse a landowner for the costs incurred in performing wildfire mitigation measures...” on private property in Colorado. Although this purpose statement only applies specifically to the new credit and not the deduction, because statute does not provide a separate purpose statement for the deduction, we considered it to have a similar purpose as the credit. We evaluated the effectiveness of the deduction at meeting the purpose we considered by measuring the extent to which it provides financial support to private landowners who incur costs related to completing wildfire mitigation activities.

Evaluation Results

We found that the Wildfire Mitigation Deduction provides landowners with a relatively small financial benefit relative to the cost of wildfire mitigation.

Exhibit 2 shows the potential tax benefit from the deduction, depending on the total cost of the wildfire mitigation project. As shown, the deduction provides no more than a \$110 tax benefit and covers, at most, 2.2 percent of the project costs. Because the deduction is capped at \$2,500, if a landowner spends more than \$5,000 on mitigation, the tax benefit would represent an even smaller percentage of the total cost of the mitigation work. For example, if a landowner spends \$10,000 on mitigation work, the tax benefit would only cover 1.1 percent of the cost.

**Exhibit 2
Potential Tax Benefit Provided by the Deduction**

Project Cost	\$1,000	\$2,500	\$5,000	\$10,000
Maximum Deduction (50 percent of costs up to \$2,500)	\$500	\$1,250	\$2,500	\$2,500
Tax Benefit Based on 4.4 Percent Income Tax Rate	\$22	\$55	\$110	\$110
Percentage of Project Cost Covered by Deduction	2.2%	2.2%	2.2%	1.1%

Source: Colorado Office of the State Auditor analysis of statute [Section 39-22-104(4)(n.5), C.R.S.].

According to CSFS, the cost to perform wildfire mitigation varies based on several factors including the type of forest, the size and location of the property, and the terrain. On average, CSFS estimates mitigation costs to be about \$1,700 per acre statewide, but can vary from about \$1,050 to \$2,100 per acre. It also notes that mitigation work around homes in wildland-urban interface areas, which requires more handwork and mastication of vegetation, costs more per acre.

In addition, there are other tax credits and programs in the state that provide a greater financial benefit to landowners who perform wildfire mitigation activities. As discussed, House Bill 22-1007, which extended the deduction, created the Wildfire Hazard Mitigation Expenses Credit, which, starting in Tax Year 2023, provides an income tax credit worth up to \$625 to landowners who perform wildfire mitigation on their property and have a federal taxable income at or below \$120,000, which will be adjusted for inflation in each subsequent tax year. The landowner can claim the credit for 25 percent of the cost up to \$2,500 in project costs. In addition, CSFS administers several programs that can help private landowners address wildfire risks. The Forest Stewardship Program provides landowners with technical assistance and, in some cases, financial assistance in managing their forest for overall health, including wildfire mitigation. Private landowners can also participate in several programs administered by CSFS that can help reduce the cost of fire mitigation, such as selling lumber through the Forest Ag or Tree Farm Programs. Finally, CSFS also administers grant programs for local governments and communities to address wildfire risks, such as the Forest Restoration & Wildfire Risk Mitigation Grant Program, although these grants are not

available for individual landowners. While these types of programs are common in other states, we did not identify any tax expenditures similar to the Wildfire Mitigation Deduction in other states.

According to Department of Revenue data, about 1,760 taxpayers claimed the deduction in Tax Year 2020, with the average deduction being about \$1,280, for an average reduction in tax liability of \$58 per taxpayer. As shown in Exhibit 3, the deduction has had a relatively small financial impact to the State.

Exhibit 3
Wildfire Mitigation Deduction Revenue Impact

Year	Revenue Impact
2015	\$68,000
2016	\$64,000
2018	\$105,000
2020	\$103,000

Source: Colorado Department of Revenue’s 2022 Tax Profile & Expenditure Report.

Policy Consideration

The General Assembly may want to review the eligibility requirements for the **Wildfire Mitigation Deduction and the Wildfire Hazard Mitigation Expenses Credit to determine if they are consistent with legislative intent.** As discussed, House Bill 22-1007 established the Wildfire Hazard Mitigation Expenses Credit to reimburse landowners for wildfire mitigation costs that, in many cases, would also qualify for the Wildfire Mitigation Deduction, with the same types of wildfire mitigation costs being eligible for both the credit and the deduction. However, there are several differences regarding eligibility for these tax expenditures. Specifically, the credit is limited to taxpayers with federal taxable income of \$120,000 or less, but can be claimed statewide and for land owned by both individuals and partnerships when there is a dwelling on the land. In contrast, the deduction has no income qualifications, but can only be claimed for mitigation work conducted in a wildland-urban interface area and is limited to land owned by individuals, and partnerships are never eligible to claim it. Therefore, an individual landowner in a wildland-urban interface area could potentially claim both the deduction and credit for qualifying wildfire mitigation costs (a potential tax benefit of \$735); whereas, if the same work was performed on land owned by a partnership or outside of a wildland-urban interface area, it would only be eligible for the credit (a potential \$625 tax benefit). Based on our review of the legislative history of House Bill 22-1007, it is not clear whether the General Assembly intended the two provisions to create a duplicative benefit or a larger potential benefit for certain taxpayers. Therefore, the General Assembly may want to review the eligibility requirements for both provisions and make changes if their current requirements are contrary to its intent.





Insurance Premium Tax-Related Expenditures



Credit for Insolvency Assessments Paid



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C O L O R A D O

Tax Expenditure Evaluation • August 2023 • 2023-TE12

When an insurer with policies written in Colorado is declared insolvent, the Colorado Life & Health Insurance Protection Association (Association) requires other insurers to pay an assessment to cover the claims of policyholders who previously purchased policies from the insolvent insurer. Life and annuity insurers are then allowed to claim a credit, spread evenly over a 5-year period, against their premium taxes owed for the amount of these assessments paid. We considered the purpose of the credit to be to reimburse life and annuity insurers for costs incurred for assessments paid to the Association and to promote stability within the insurance industry.

The credit is meeting its purpose because insurers are generally aware of the credit and most of the available credit amount has been claimed. Additionally, the credit effectively reimburses life and annuity insurers to cover costs associated with assessments paid to the Association.

- According to Division of Insurance staff, the Association, and stakeholders, the credit is commonly known about and used across the industry, providing an important reimbursement for the costs of assessments levied by the Association.
- The credit appears to sufficiently reimburse insurers to cover assessment costs, thereby reducing the risk of instability across insurers in the industry.
- The credit may also prevent the costs of assessments from being passed on to future policyholders in the form of increased policy rates.

Policy Considerations

We did not identify any policy considerations in this evaluation.

Tax Type:	Insurance Premiums	Year Enacted:	1991
Expenditure Type:	Credit	Repeal/Expiration Date:	None
Statutory Citation:	Section 10-20-113(1)(a), C.R.S.	Revenue Impact (2018 to 2022):	\$305,000

Purpose given in statute or enacting legislation? **No**

Credit for Insolvency Assessments Paid

Background

The Colorado Division of Insurance (Division) is responsible for monitoring and regulating state insurance activity to provide a financially stable insurance market and to protect policyholders if insurance companies no longer have the capital to provide coverage for future claims and benefits of policyholders. The Division determines when an insurance company is in financial distress and should be declared insolvent, at which point the Division assumes control of the company's assets and liabilities and pays the company's outstanding claims.

However, insolvent insurers do not always have the funds necessary to cover outstanding claims and other liabilities. In these cases, the Colorado Life & Health Insurance Protection Association (Association), which was created under Section 10-20-106 and 108, C.R.S, requires its member insurers to pay an assessment to cover the claims of policyholders who previously purchased policies from the insurer that became insolvent. These assessments are called class B assessments (assessments) and they are assessed against all life, annuity, or health insurers that are members of the Association in an amount sufficient to cover the insolvent insurer's outstanding claims. The assessment each insurer pays is proportionate to their market share of premiums collected in the state, capped at 2 percent of each insurance company's average premiums from the most recent 3 years. While health insurers and HMOs may raise policy rates to cover the assessment cost, life and annuity insurers are allowed a premium tax credit to offset the assessment cost.

Technical Note:

Statute defines a member insurer as any insurer that is licensed or holds a certificate of authority in the state to write any kind of insurance [Section 10-20-103(8), C.R.S]. House Bill 23-1303 added health maintenance organizations (HMOs) as member insurers.

The Credit for Insolvency Assessments Paid allows life and annuity insurers to claim a premium tax credit, divided evenly over a 5-year period (i.e., insurers claim 20 percent of their assessment amount paid against their premium taxes each year) following the payment of the assessment to the Association.

Following an assessment, the Association provides insurers with a Credit for Contribution Certificate that outlines the amount of credits they are eligible to claim against their premium tax liability, which insurers submit to the Division when filing their premium tax return.

If a member insurer does not have sufficient tax liability to use the credit, the insurer may carry the credit forward to future years. Additionally, the total combined credit amount that all member insurers can claim is capped at \$4 million annually, with excess amounts carried forward; however, based on discussions with the Association, the total amount certified has not exceeded the statutory cap.

While statute does not state a purpose for the Credit for Insolvency Assessments Paid, **we considered the purpose to be to reimburse life and annuity insurers for costs incurred for assessments paid to the Association and to promote stability within the insurance industry.** Specifically, based on our review of legislative audio from the credit's enactment, the General Assembly created the Association, along with assessments, to cover policies that were already purchased to ensure that policyholders were protected during an insolvency. However, there was concern that assessments for life and annuity insurers, who sell fixed premiums and cannot quickly cover additional expenses with a policy rate change, could create additional financial hardships for these types of insurers and lead to instability in the industry and additional insolvencies. Therefore, the General Assembly created the credit to offset the cost of assessments that life and annuity insurers have to absorb. This approach is similar to the policies of other states. All 50 states, including the District of Columbia, have an Association that is part of the National Organization of Life and Health Insurance Guaranty Associations, and 43 states plus the District of Columbia provide a tax credit for insolvency assessments paid by life and annuity insurers. Because health insurers sell policies on a more short-term basis, statute instead allows them to recoup assessment costs through policy rate increases and they are not eligible for the credit.

We considered the intended beneficiaries of the Credit for Insolvency Assessments Paid to be life and annuity insurance companies that can claim the credit to recoup their assessment costs, as well as future policyholders who are likely protected from rate increases due to insurers recouping, rather than passing on, some of the assessment costs.

We developed the following performance measures to evaluate the tax expenditure:

- Are insurers aware of and using the Credit for Insolvency Assessments Paid?
- Does the Credit for Insolvency Assessments Paid effectively reimburse life and annuity insurers to cover costs incurred from assessments paid to the Association, reduce the risk of instability in the industry, and help protect policyholders?

Evaluation Results

The Credit for Insolvency Assessments Paid is meeting its purpose because insurers are generally aware of the credit and most of the available credit amount has been claimed.

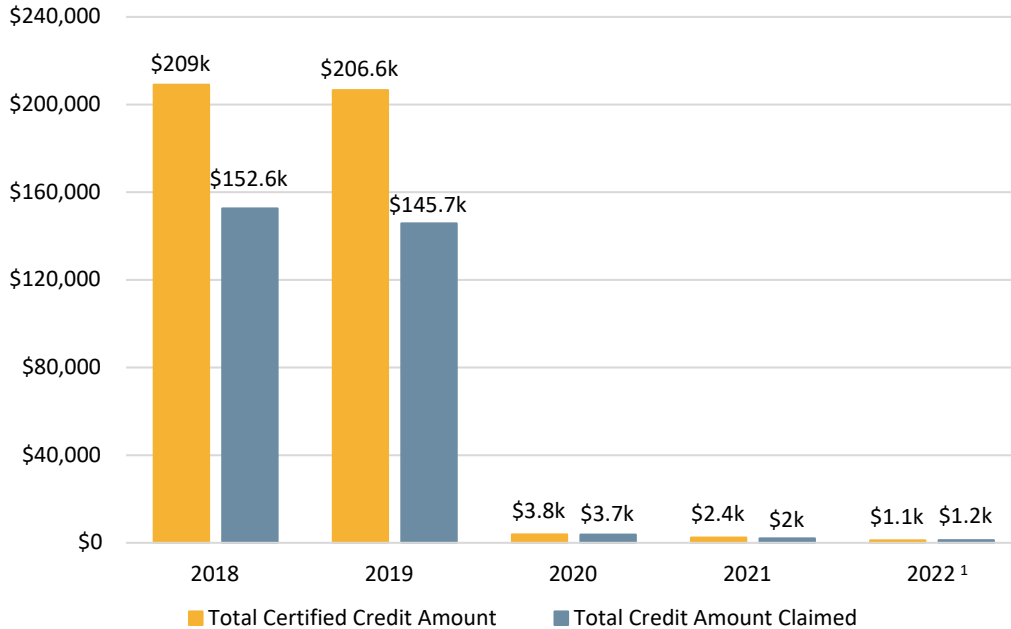
Additionally, the credit effectively reimburses life and annuity insurers to cover costs associated with assessments paid to the Association.

Life and annuity insurers are aware of and claiming the credit. Based on our discussions with Division staff, the Association, and stakeholders, we found that the credit is commonly known and used across the insurance industry. For example, discussions with the Association, member insurers, and trade associations indicated that insurance companies are aware of the credit and the credit provides an important reimbursement for the costs of assessments levied by the Association. In addition, because similar credits are available in most states, insurers that operate in multiple states are likely to be familiar with the credits.

Most insurers claimed the credits they were eligible to claim in recent years. Based on data provided by the Division and the Association, we found that insurers claimed about \$305,000 of the nearly \$423,000 in credits certified by the Association from Tax Year 2018 through 2022, with a single insurer accounting for nearly 95 percent of the total unclaimed amount. Other insurers' unclaimed amounts were relatively small, ranging from less than \$1 to about \$5,000 per year. In our discussions with Division staff, they did not know why certain insurers did not claim the full amount of tax credits they were eligible to claim. Exhibit 1 compares the amount of credits insurers claimed and the amount they were certified to claim from Tax Years 2018 through 2022 for a large assessment levied in 2014 and a smaller assessment levied in 2017, which led to higher credit certifications in 2018 and 2019 and lower amounts in subsequent years. As discussed above, insurers are allowed to claim 20 percent of their assessment amount paid as a credit against their premium taxes each year for 5 years. This means that in 2018 and 2019, insurers were able to claim their credits from the larger assessment amount from 2014 and the smaller 2017 assessment.

Exhibit 1

Credits Claimed and Credits Certified for Tax Years 2018 through 2022



Source: Colorado Office of the State Auditor analysis of data provided by the Colorado Division of Insurance (Division) and the Colorado Life & Health Insurance Protection Association.

¹The amount claimed in Tax Year 2022 is slightly higher than the amount certified, however, the Division did not provide a response to why this occurred.

The Credit provides life and annuity insurers with a sufficient reimbursement to cover assessment costs to reduce the risk of instability in the industry.

Stakeholders indicated that the credit is generally sufficient to cover insurers payments and reduce the financial risks that could occur in the industry as a result of assessments levied against member insurers. Due to the credit being paid over 5 years and inflation reducing the value of money over time, insurers do not receive the full value of the assessments they pay, but the credit covers almost all of it. For example, based on a hypothetical \$100 assessment levied against an insurance company, assuming a 2 percent discount rate based on the Federal Reserve Board's target inflation rate, the credit offsets about 94 percent the insurer's assessment costs. However, because assessments in recent years have been relatively small, it is unlikely that they would have had a significant impact on the insurance industry regardless of the credit. For example, the most recent assessment occurred in 2017, with payments from insurers ranging from \$2.80 to \$852, with a median of \$76. While such a small cost is unlikely to have created financial instability for insurers, if more substantial insolvencies resulting in greater assessments levied on member insurers occurred in future years, this would increase the importance of the credit in mitigating insurers' solvency risks.

In addition to meeting its purpose, we also determined that the credit may prevent future policyholders from covering the cost of the assessment through increased policy rates. The

credit may also benefit insurance consumers by allowing insurance companies to avoid passing the cost of assessments on to policyholders in the form of higher premiums, although it is unclear the extent to which this would occur in the absence of the credit. Generally, life and annuity insurers are limited in their ability to pass costs on to current policyholders because they cannot raise fixed policy premium rates. However, life and annuity insurers could pass the cost of the assessment on to future policyholders by charging higher life and annuity policy rates. Economic research suggests that consumers' demand for life and annuity insurance is less responsive to price changes, indicating that life and annuity insurers would likely pass on most of the increased cost of assessments in the form of future policy rate increases if they did not receive a reimbursement through the tax credit. Additionally, based on discussions with stakeholders, the credit could be important to smaller domestic insurers in Colorado that receive a relatively larger portion of their premium revenue from Colorado policyholders. Because these insurers have less premium revenue from other states, an assessment in Colorado may be more difficult for them to absorb, as compared to larger insurers for which Colorado policies may make up a small portion of their total premium revenue.

Policy Considerations

We did not identify any policy considerations.

Structural Insurance Premium Tax Expenditures



OFFICE OF THE STATE AUDITOR
C O L O R A D O

Tax Expenditure Evaluation • February 2023 • 2023-TE5

Colorado levies a 2 percent insurance premium tax on the premiums insurers collect from policyholders in the state. The Structural Insurance Premium Tax Expenditures help define the State’s system for taxing insurers and establish the amount of premiums that are subject to the insurance premium tax. The tax expenditures include:

- The Insurance Premium Income Tax Exemption, which exempts insurers from the State’s corporate income tax.
- The Return Premium and Early Termination Deductions, which allows insurers to deduct premiums that they later refunded to policyholders when calculating the premium amount that is subject to the premium tax.
- The Reinsurance Deduction, which exempts reinsurance (i.e., insurance premiums assumed by another insurer) from the premium tax.

Together these expenditures prevent the double taxation of insurers and define the premiums that are taxable in Colorado.

The Structural Insurance Tax Expenditures are meeting their purpose because insurers are generally aware of and using them.

Insurers and the Division of Insurance reported that these tax expenditures are commonly used in Colorado and we found that they are also common in other states. Insurers account for refunded and returned premiums, as well as reinsurance as part of their financial reporting processes. Therefore, the state deductions are already subtracted from total premiums prior to reporting their taxable premiums to the Division of Insurance.

Policy Considerations

We did not identify any policy considerations in this evaluation.

	Insurance Premium Income Tax Exemption	Return Premium Deduction	Early Termination Deduction	Reinsurance Deduction
Tax Type:	Income	Insurance Premiums	Insurance Premiums	Insurance Premiums
Expenditure Type:	Exemption	Deduction	Deduction	Deduction
Statutory Citation:	Section 39-22-112(1), C.R.S.	Section 10-3-209(1)(a), C.R.S.	Section 10-3-209(1)(a), C.R.S.	Section 10-3-209(1)(a), C.R.S.
Year Enacted:	1937	1913	1973	1913
Repeal/Expiration Date:	None	None	None	None
Revenue Impact:	We could not determine	We could not determine	We could not determine	We could not determine
Purpose given in statute or enacting legislation? No				

Structural Insurance Premium Tax Expenditures

Background

Colorado levies an insurance premium tax (generally set at 2 percent) on the premiums insurers collect from policyholders in the state. Most types of insurance sold in the state, including property and casualty (e.g., auto and homeowners' insurance), life, health, and title insurance are subject to the insurance premium tax. This evaluation covers four tax expenditures—referred to collectively as the Structural Insurance Premium Tax Expenditures—that help define the State's system for taxing insurers and establish the amount of premiums that are subject to the insurance premium tax.

The Insurance Premium Income Tax Exemption exempts insurance companies from the state corporate income tax because they are instead subject to the insurance premium tax.

Colorado created the insurance premium tax in 1913, before it established a corporate income tax. In 1937, when Colorado adopted an income tax, the law included the Insurance Premium Income Tax Exemption to exempt insurers from paying income tax. Due to operational and accounting differences in the insurance industry, taxing insurers using a premium tax can be less complicated to compute, collect, and administer, and provides a more stable source of revenue for the State compared to a state income tax. Specifically, insurers need to maintain funds in reserve to pay off future claims and benefits of policyholders; however, the unpredictable timing and amount of future claims and benefits payments can make it difficult to determine how much of the premiums collected by insurers and held in reserve will ultimately result in net income to the company after it makes payments to policy holders. Consequently, it is difficult to compute the taxable income of insurers while allowing for needed reserves.

Technical Notes

Captive insurers (i.e. subsidiary insurers that provide insurance to their non-insurance parent company) with a majority of their income not from insurance premiums do not qualify for the Insurance Premium Income Tax Exemption and instead pay corporate income taxes.

The Return Premium Deduction allows insurers a deduction for premiums they returned or credited to policyholders. The Return Premium Deduction includes dividends or unabsorbed premiums or premium deposits that were returned or credited to policyholders.

The Early Termination Deduction allows insurers to subtract premiums that were terminated or cancelled prior to their maturity date. The Early Termination Deduction applies to credit life, credit accident, and health insurance policies. Credit insurance policies are occasionally

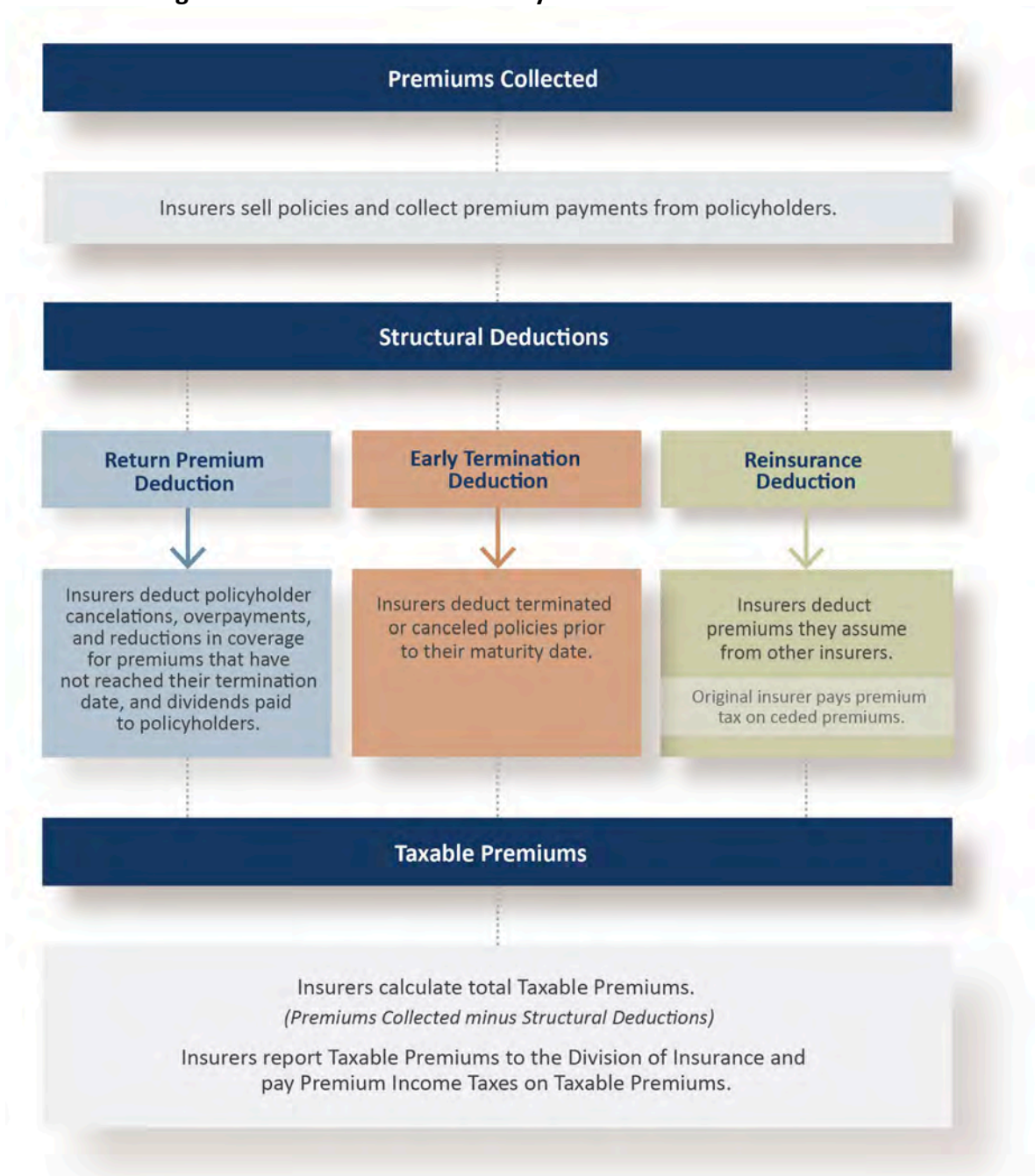
taken out by debtors in conjunction with their credit cards, auto loans, and mortgages to ensure that their debt is paid off in case they die (in the case of credit life) or become ill or injured and, consequently, unable to work (in the case of credit accident).

The Reinsurance Deduction allows reinsurers to deduct reinsurance premiums they receive from other insurers because the initial insurer is responsible for the premium tax.

Reinsurance serves as insurance for insurance companies. Insurance companies that issue policies and wish to transfer the policies' risk can purchase reinsurance, which requires them to pay a premium to the reinsurer, effectively transferring some or all of the premiums they receive on the original policy. Insurance companies purchase reinsurance, which is commonly used within the industry, to expand their capacity to write additional policies, stabilize underwriting results, access additional financing, provide catastrophe protection, withdraw from a class of business, spread risk, or acquire expertise.

Exhibit 1 shows how insurers write premiums and account for the Structural Insurance Premium Tax Expenditures on their financial statements to determine their premium tax liability which is reported and remitted to the Division of Insurance (Division).

Exhibit 1
Determining Insurers Premium Tax Liability



Source: Section 10-3-209(1)(a), C.R.S., and Office of the State Auditor analysis of the operation of the Structural Insurance Premium Deductions.

We considered the intended beneficiaries of the Structural Insurance Premium Tax Expenditures to be insurance companies that are subject to the State’s insurance premium tax. In Calendar Year 2021, there were 1,517 insurance companies required to file premium taxes in Colorado, and a total

of \$51 billion in premiums paid by Colorado consumers. According to Office of the State Controller, the State collected \$336.3 million in insurance premium taxes in Fiscal Year 2021.

While statute does not state a purpose for the Structural Insurance Premium Tax Expenditures, based on our review of their operation and legislative history, we considered them to have the following purposes:

- **The Insurance Premium Income Tax Exemption avoids double taxing insurers.** Insurers' premiums are subject to the State's insurance premium tax which is levied on insurers in lieu of the State's corporate income tax.
- **The Return Premium and Early Termination Deductions prevents taxation of the portion of premiums that insurers return or refund to policyholders.** The deductions allow insurers to avoid tax on these revenues since insurers cannot retain them as profit or use them to pay claims on policies.
- **The Reinsurance Deduction prevents double taxation of insurance premiums collected on policies that are later reinsured.** Because the premiums an insurer collects on an original policy that is the basis of a reinsurance policy it purchases are likely already taxed, taxing the reinsurance premiums would effectively result in a double tax.

We developed the following performance measures to evaluate the tax expenditures:

1. Are insurers aware of and paying the premium tax instead of the state corporate income tax?
2. Are insurers aware of and using the return premium and early termination deductions?
3. Are insurers aware of and using the reinsurance deduction?

Evaluation Results

The Structural Insurance Premium Tax Expenditures are meeting their purpose because insurers are generally aware of and applying them.

We found that insurers are aware of and using the Structural Insurance Premium Tax Expenditures. Based on our discussions with Division staff and stakeholders—and review of Division forms—both during the current evaluation and our 2019 evaluation of these tax expenditures, we found that these provisions are commonly known and used across the insurance industry. However, we lacked the data necessary to quantify their use because insurers are not required to report this information to the Division. In addition, these tax expenditures are also common across other states. Specifically,

- Similar to Colorado, 46 of the 48 other states (including the District of Columbia) with a corporate income tax (or similar type of business tax) exempt insurance companies from their income tax and instead levy a tax on premiums.
- We were able to identify at least 45 other states that had a tax provision similar to the Return Premium Deduction and/or the Early Termination Deduction.
- Stakeholders reported that most states exclude reinsurance premiums from the premium tax base, and we identified at least 25 other states that have explicit deductions for reinsurance.

Therefore, insurers, many of which operate in other states in addition to Colorado, are likely familiar with these types of tax expenditures.

We were not able to determine how much insurers claimed for the Structural Insurance Premium Tax Expenditures or their revenue impact to the State because insurers do not report the amounts claimed to the Division when filing their insurance premium tax. However, we identified research indicating that the Insurance Premium Income Tax Exemption may not decrease state revenue. Specifically, although insurers are exempt from the State's corporate income tax, levying a tax on insurers' premiums as a substitute may instead result in the State collecting a greater amount of total taxes from insurers. Research from the Fiscal Research Center at Georgia State University indicated that, nationally, insurance companies pay roughly double the amount in premium taxes than they would otherwise pay if they were instead subject to the corporate income tax, although we lacked data to quantify the difference in Colorado.

Policy Considerations

We did not identify any policy considerations for the Structural Insurance Premium Tax Expenditures. In our previous evaluation of the Structural Insurance Premium Tax Expenditures, released January 2019, we included a policy consideration that the General Assembly may want to consider allowing insurers to deduct from their premium tax base the amount of any licenses, fees, or taxes they pay to local governments. The General Assembly did not take any legislative action on this policy consideration.



Sales and Use Tax-Related Expenditures



Agricultural Sales Tax Exemptions



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Tax Expenditure Evaluation • August 2023 • 2023-TE13

The Agricultural Exemptions eliminate the state sales and use tax on most farming and ranching inputs—such as livestock and agricultural compounds—along with farm equipment and special fuel used in farm vehicles.

Based on data from the U.S. Department of Agriculture, the U.S. Energy Information Administration, and the Department of Revenue, we estimate the revenue impact of the exemptions was more than \$200 million in 2021.

The exemptions are meeting their purposes because eligible Colorado farmers and ranchers are aware of them and the exemptions appear to be applied to eligible sales; however, the financial benefits from the exemptions vary based on local sales tax policies.

Policy Considerations

We did not identify any policy considerations in this evaluation.

	Agricultural Inputs	Farm Equipment & Parts	Special Fuel for Use in Farm Vehicles
Tax Type:	Sales and Use	Sales and Use	Sales and Use
Expenditure Type:	Exemption	Exemption	Exemption
Statutory Citation:	Sections 39-26-102(9) and (19)(c)-(f), 39-26-104(1)(a), and 39-26-716(4)(a)-(c), C.R.S.	Section 39-26-716(4)(e) and (f), C.R.S.	Section 39-26-716(4)(d), C.R.S.
Year Enacted:	1943 - 2019	1999	1977
Repeal/Expiration Date:	None	None	None
Revenue Impact:	\$249.5 million (2021)	\$16.8 million (2021)	\$1.9 million (2021)
Purpose given in statute or enacting legislation? No			

Agricultural Sales Tax Exemptions

Background

This evaluation covers several sales and use tax exemptions that apply to the agricultural industry, referred to collectively in this report as Agricultural Exemptions. These exemptions can be categorized into three groups:

- **The Agricultural Inputs Exemptions—exempt most inputs to agricultural operations from state sales and use tax, including the following:**
 - Livestock
 - Feed for livestock
 - Agricultural compounds used in caring for livestock
 - Semen for agricultural or ranching purposes
 - Fish for stocking purposes (*We have included “aquaculture”—the process of raising fish for commercial sale—within our use of the term “agriculture” in this tax evaluation.*)
 - Fertilizer for use in the production of agricultural commodities
 - Spray adjuvants used in caring for livestock or in the production of agricultural commodities
 - Pesticides registered by the commissioner of agriculture for use in the production of agricultural and livestock products
 - Seeds
 - Orchard trees

Most of these exemptions were created between 1943 and 1999; in 2019 the General Assembly created the exemption for fertilizers used in the production of agricultural commodities.

- **The Farm Equipment and Parts Exemption—exempts sales and purchases of farm and dairy equipment from state sales and use tax.** To qualify for the exemption, the equipment must be used directly and primarily for a farm, ranch, or livestock production operation. Additionally, dairy equipment must be used at a farm dairy in connection with the production of raw milk and not at a commercial dairy or in connection with the production of pasteurized, separated milk products for retail sale. Examples of equipment that qualify include tractors, irrigation equipment with a purchase price of at least \$1,000, baling wire, cow identification systems, transponders, and milk containment tanks. Qualifying farm equipment also includes

parts that are used in the repair or maintenance of farm equipment, regardless of purchase price. The exemption also covers farm equipment under lease or contract if the fair market value is at least \$1,000. Equipment, materials, and supplies used on the farm but not directly in the farm operations (e.g., office supplies or equipment used in the sale or distribution of farm products) are not included in the exemption.

The exemption was created in 1999 and expanded in 2000 and 2001 to include parts used to repair and maintain equipment and dairy equipment and parts to the list of eligible items. In 2019, with House Bill 19-1162, the General Assembly expanded the exemption to include farm equipment and systems to identify or track food animals, such as ear tags and ear tag scanners. Identification and tracking equipment and systems were already exempt for dairy cows, but House Bill 19-1162 extended the exemption to include equipment and systems, specifically electronic and non-electronic ear tags and ear tag scanners, used by non-dairy farms like beef and pork producers to track and identify food animals (such as cattle and pigs) and animals used in the production of food. The purpose of this extension was to provide Colorado's non-dairy animal farmers the same tax benefits as its dairy farmers.

- **The Special Fuel for Use in Farm Equipment Exemption—exempts from state sales and use tax sales of special fuel used for the operation of vehicles used on farms and ranches.** Special fuel means diesel engine fuel, kerosene, liquefied petroleum gas, and natural gas, but does not include gasoline. The exemption was created in 1977 and has remained substantively unchanged since that time.

The Agricultural Exemptions are typically applied at the point of sale. When selling or leasing farm equipment, the vendor is responsible for obtaining a signed affidavit (Form DR 0511) from the person buying or renting the equipment affirming that they will use the equipment primarily and directly in a farm operation. Vendors report exempt sales on the Department of Revenue's (Department) Retail Sales Tax Return (Form DR 0100).

We considered the beneficiaries of the Agricultural Exemptions to be ranchers, farmers, and people who raise fish for commercial sale. According to the U.S. Department of Agriculture (USDA) data, in 2022, there were 39,000 farms and ranches in Colorado with an average size of 815 acres. In 2018, which is the most recent year of aquaculture data available, there were 17 aquaculture farms.

While statute does not state a purpose for the Agricultural Exemptions, based on our review of their operation and legislative history, we considered the exemptions to have several potential purposes, as follows:

- **Ensure that sales and use tax is only levied on consumers making purchases of finished agricultural products instead of agricultural producers who may not be able to absorb the additional tax.** A general principle of sales and use tax is for the consumer of the final product to pay the tax and, therefore, not apply sales and use tax to earlier steps in a product's

supply and distribution chain. Agricultural producers are typically “price takers” because the price of most agricultural products is set by national and international markets and individual producers are typically unable to increase the sales price they receive beyond established market rates. Therefore, if the State’s sales and use tax were levied at multiple points in an agricultural product’s supply and distribution chain or on equipment necessary for agricultural operations, Colorado’s agricultural producers would likely have to absorb most of the increased taxes, effectively decreasing their after-tax income. Most farms and ranches operate on small profit margins so absorbing these additional taxes would potentially cause farmers and ranchers significant financial distress. According to the USDA, in 2021, 71 percent of farms in the United States had a profit margin of below 10 percent and were thus high-risk for financial problems.

The Agricultural Exemptions are similar to exemptions the State offers for other industries, like manufacturing, that ensure sales and use tax is only paid when a product is sold to the final consumer. For example, statute [Section 39-26-102(20)(a), C.R.S.] exempts manufacturing inputs, such as raw materials that will become part of a product that will be sold to consumers, from sales and use tax. Statute [Section 39-26-709(1)(a)(II), C.R.S.] also exempts machinery used in manufacturing from sales and use tax because it is necessary for the production of the final product that will be sold to a consumer. Finally, statute [Section 39-26-102(21)(a), C.R.S.] also exempts energy and fuel used in manufacturing from sales and use tax because it is also a necessary component of the manufacturing process.

- **Prevent what is known as “tax pyramiding,” which occurs when each transaction in a product’s supply and distribution chain is subject to tax.** Tax pyramiding can cause economic distortions, since less tax is paid for products with shorter supply and distribution chains, and can raise the price end consumers pay to the extent that the businesses in a product’s production and distribution chain pass the cost of sales tax on to the next business in the distribution chain by increasing their prices. Tax pyramiding also decreases the transparency of the tax system, since final consumers generally are not able to determine how much of the sales price they pay is due to taxes levied during the production and distribution of the product. Therefore, in addition to farmers and ranchers, consumers of agricultural products could benefit from the Agricultural Exemptions because they are not paying for taxes previously levied on the product and can more easily determine the sales tax rate on their purchases.
- **Maintain consistency with other exemptions for food.** Additionally, the General Assembly has exempted many food items from sales tax through the Food for Home Consumption Exemption [Sections 39-26-707(1)(e) and (2)(d) and 714(2), C.R.S.] and the Food Ingredients Exemption [Sections 39-26-102(20)(b)(I) and 39-26-713(2)(b) and (e), C.R.S.], among others. If the State levied sales tax on inputs, machinery, or fuel used to produce food items, consumers could pay some portion of the tax through higher prices, which would undermine the purpose of the exemptions for food items.

To determine whether the Agricultural Exemptions are meeting their purposes, we assessed the extent to which eligible taxpayers are aware of and using the exemptions.

Evaluation Results

We found that, overall, the Agricultural Exemptions are meeting their purposes because Colorado’s farmers and ranchers are aware of and applying them. In our previous report on the Agricultural Inputs Exemptions, published in January 2019, we found that they were meeting their purpose after speaking to 18 stakeholders and concluding that Colorado’s agricultural industry was generally aware of and applying the exemptions. In our previous report on the Farm Equipment and Parts Exemption, published in January 2022, we found that this exemption was meeting its purpose after reaching out to 18 stakeholders and interviewing three of them—all of whom were aware of and using the exemption.

For this report, we reached out to six of those stakeholders and interviewed three—all of whom confirmed that they still used the exemptions. We also contacted an additional seven stakeholders and spoke with two about the exemptions that have been amended or enacted since 2019—Special Fuel for Farm Vehicles, Farm Equipment and Parts, and Fertilizers—to determine whether they are aware of and applying the exemptions. All of the stakeholders with whom we spoke were aware of the new or modified exemptions.

The financial benefits from the Agricultural Exemptions vary based on local sales tax policies. Although all purchases of eligible items are exempt from state sales taxes, only some local governments apply the exemptions. Specifically, all of the State’s statutory cities and counties (which have their local sales taxes collected by the State on their behalf) must adopt all of the Agricultural Inputs and Special Fuel for Farm Vehicles Exemptions. In contrast, under Section 29-2-105(1)(d)(I)(F), C.R.S., statutory cities and counties may opt into the Farm Equipment and Parts Exemption by enacting a local ordinance. Additionally, statutory cities and counties that opted into the Farm Equipment and Parts Exemption prior to August 2, 2019 have the option to enact an additional local ordinance to exempt identification and tracking equipment and systems for food-producing animals, which the General Assembly included under the statutory definition of “farm equipment” in 2019. Conversely, statutory cities and counties that opt to exempt farm equipment and parts on or after August 2, 2019 must also exempt these equipment and systems. According to the Department, 23 of the 52 statutory counties and 15 of the 160 statutory cities that levy a sales tax have opted to exempt farm equipment and parts.

These varying tax policies can result in significant differences in the tax savings provided by the exemptions, as our example tractor purchase scenario illustrates in Exhibit 1. As shown, a farmer purchasing a new \$80,000 tractor in Fruita would save \$4,000 in city and county taxes because both the city of Fruita (with a 3 percent sales tax) and the county of Mesa (with a 2 percent sales tax) exempt farm equipment from sales taxes. These savings would be in addition to the \$2,320 in state sales taxes saved due to the Farm Equipment and Parts Exemption, which would exempt the purchase from the 2.9 percent state sales tax. In sum, the farmer would have a savings of 7.9 percent. Meanwhile, a farmer buying the same \$80,000 tractor in Granada would not have any

savings in city or county taxes, as neither the city of Granada nor the county of Prowers exempt farm equipment from sales taxes. However, the farmer would save the same \$2,320 in state sales taxes as the farmer in Fruita. Overall, this farmer would have a savings of 2.9 percent.

Exhibit 1

Comparison of Hypothetical Sale of a Tractor in Two Jurisdictions with Different Local Sales Tax Treatment of Farm Equipment



Source: Office of the State Auditor analysis of state and local government tax rates.

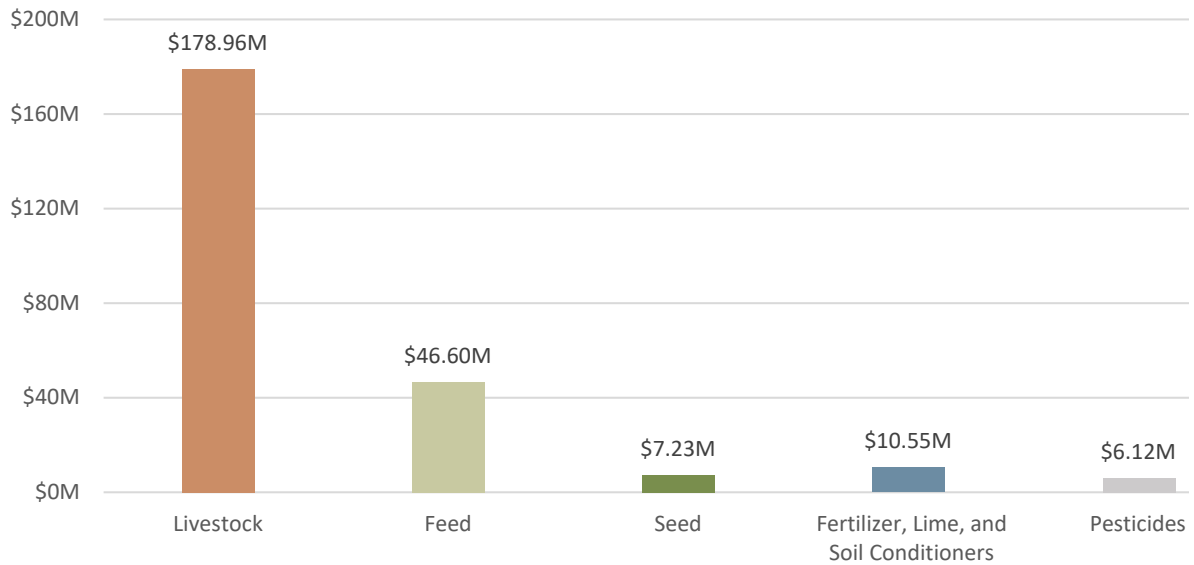
Additionally, Colorado’s home rule cities and counties, established under Article XX of the Colorado Constitution, that collect their own sales taxes are *not* required to conform to any of the State’s tax policies, including the Agricultural Exemptions. We looked at home rule cities in Colorado’s 20 counties with the most farm land, and found they vary greatly in terms of which of the Agricultural Exemptions they offer. For example, Craig, Sterling, and Windsor have adopted all of the Agricultural Exemptions, whereas many larger Front Range cities, including Colorado Springs, Greeley, and Thornton, have adopted few, if any, of the exemptions.

We estimate that the Agricultural Sales Tax Exemptions provide more than \$200 million in annual tax savings to Colorado’s agricultural producers.

- **Agricultural Inputs Exemptions**—We estimate that agricultural producers received at least \$249.5 million in tax savings from the exemptions in 2021. Exhibit 2 shows the estimated revenue impact by agricultural input type.

Exhibit 2

Estimated Revenue Impact of Agricultural Inputs Exemptions in Tax Year 2021



Source: Office of the State Auditor analysis of USDA data.

We used USDA statistical reports for our estimate, which provide estimated expenses for inputs purchased by Colorado farmers and the value of livestock sales by Colorado producers. However, these data have several limitations that likely impact the accuracy of our estimate. First, the USDA data set that we used does not include data for all the agricultural inputs exempt from Colorado sales tax, so it is possible that the actual revenue impact to the State and corresponding tax savings to agricultural producers is greater than \$249.5 million. Specifically, the USDA data do not include data on agricultural compounds, semen for agricultural or ranching purposes, fish for stocking, or orchard trees. Second, we used USDA data on cash receipts for meat animals sold by Colorado producers in our estimate for the livestock exemption, which likely includes some sales made to out-of-state purchasers who would not be subject to sales tax regardless of the exemptions. We attempted to account for livestock sales to out-of-state consumers by subtracting exports of live farm animals from Colorado producers' cash receipts of meat animals; however, it is possible this does not account for all sales of livestock to out-of-state consumers. It is also possible that our revenue impact estimate of the Livestock Exemption (based on USDA data) double counts some transactions and thus overestimates the revenue impact. This is because we included in our estimate both expenses reported by Colorado producers who purchased livestock as well as cash receipts from sales of livestock by Colorado producers. To the extent that a Colorado producer purchased livestock from another Colorado producer, that transaction would be reflected in both the expenses of the purchaser and the cash receipts of the seller. However, we lacked data on how many transactions were between in-state sellers.

When we evaluated the Agricultural Inputs Exemptions in 2019, these exemptions were not itemized on the Retail Sales Tax Return. At that time, we estimated the revenue impact using USDA data, and found that it was likely around \$231.2 million in 2017. In 2020, the Department amended its Retail Sales Tax Return so that the Agricultural Inputs Exemptions are reported on their own line on the return, and the Department is now able to extract that data from the returns. Most of the Agricultural Input Exemptions are reported in aggregate on a line for “Exempt agricultural sales, not including farm and dairy equipment” (Schedule A, Line 10). According to Department data, the State revenue impact of the Agricultural Inputs Exemptions was \$20.9 million in 2021 based on amounts reported on the Retail Sales Tax Returns; this amount also includes the Farm Closeout Sales Exemption, which we reported on in May 2023, but we think that it is a relatively small portion of the total amount. However, it is likely that the Department’s data significantly underreports the actual revenue impact to the State and corresponding tax savings to agricultural producers of the Agricultural Inputs Exemption. Our estimates for 2017 and 2021 are much higher than the revenue impact reported by the Department for 2021 due to several factors: (1) since the reporting line for the exemptions on the Retail Sales Tax Return changed in 2020, some retailers may not have realized the return was changed and may still be reporting the Agricultural Inputs Exemptions on the “Other Exemptions” line of the return; (2) if a vendor only makes exempt sales of commodities, they are not required to file a sales tax return and therefore, those exempt sales would not be reported to the Department on any forms; and (3) the agricultural items in the USDA data do not align exactly with the items covered by Colorado’s exemptions.

- **Farm and Equipment and Parts Exemption**—According to Department data, the State revenue impact of the Farm Equipment and Parts Exemption was about \$16.8 million in 2021 based on amounts reported on the Retail Sales Tax Returns. Exempt sales of farm and dairy equipment are reported on a separate line of the Retail Sales Tax Return (Schedule B, Line 4).
- **Special Fuel for Farm Vehicles Exemption**—According to data from the U.S. Energy Information Administration (EIA), in 2020, Colorado farmers spent approximately \$66.7 million on diesel fuel, which translates into a state revenue loss and corresponding savings by farmers of approximately \$1.9 million. Although this exemption is reported on the Retail Sales Tax Return as well (“Sales of gasoline, dyed diesel, and other exempt fuels,” Schedule A, Line 5), we based our estimate on EIA data because the exemption is reported on the same line of the return with three other fuel exemptions—gasoline, special fuel used on State highways, and aviation gasoline—and we were unable to determine the amount reported just for the Special Fuel for Farm Vehicles Exemption. In 2021, the total State revenue impact for all the exemptions reported on that line was about \$370.4 million. However, it is likely that the majority of that amount is attributable to the other exemptions reported on that line.

The Agricultural Exemptions might help keep Colorado farmers competitive with farmers in other states. All 44 other states that impose a retail sales or similar tax provide exemptions for items used by the agricultural sector, although the types of items exempted and their administration

vary. We reviewed the specific exemptions available in neighboring states and Texas, which we included in our analysis because stakeholders with whom we spoke indicated that many agricultural goods used or produced in Colorado are purchased from or sold to Texas. Exhibit 3 illustrates that while there are some differences between these states regarding the exemption of some items, most agricultural inputs are not subject to sales tax in most of the states we reviewed. Like Colorado, most of these states have additional requirements for claiming the exemptions, such as requiring the purchaser to meet the definition of “farmer” and use the items purchased for an agricultural purpose.

Exhibit 3

Agricultural Sales & Use Tax Exemptions of Colorado’s Neighbor States with National Agricultural Sales Ranking

Exemption	Colorado ¹	Nebraska (#3)	Texas (#4)	Kansas (#7)	Oklahoma (#22)	Arizona (#31)	New Mexico (#34)	Utah (#37)	Wyoming (#38)
Agricultural Machinery & Equipment	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Livestock	Exempt	Exempt	Exempt	Exempt	In certain circumstances	Exempt	Exempt	Exempt	Nontaxable
Poultry	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Nontaxable
Livestock Bedding	Exempt	Taxable	Exempt	Taxable	Exempt	Taxable	Taxable	Exempt	Exempt
Animal Feed	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Nontaxable
Antibiotics, Medicines & Vaccines	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	In certain circumstances	Exempt	Taxable
Growth Promotants	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	In certain circumstances	Taxable
Semen	Exempt	Exempt	Exempt	Exempt	Exempt	No guidance	Exempt	No guidance	Taxable
Fertilizers	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt
Pesticides	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	Exempt	In certain circumstances	Exempt
Energy & Fuel	Exempt	Nontaxable	Exempt	Exempt	Exempt	Taxable	Taxable	Exempt	Exempt

Source: Office of the State Auditor analysis of Bloomberg Industry Group data on U.S. state tax policies and U.S. Department of Agriculture data on agricultural commodity cash receipts.

¹ Colorado ranks 20th in agricultural sales among states.

Policy Considerations

We did not identify any policy considerations for the Agricultural Exemptions. In our previous evaluation of the Agricultural Inputs Exemptions released January 2019, we included the policy consideration that the General Assembly may want to review and clarify statutes specifying which agricultural inputs are exempt. Specifically, we stated that the General Assembly may consider clarifying whether the following agricultural inputs were intended to be exempt from sales and use tax: 1) fertilizers; 2) soil conditioners, plant amendments, plant growth regulators, mulches, compost, and manure; 3) fish for non-stocking purposes (as opposed to fish sold for stocking purposes, which are explicitly exempted); and 4) embryos/fish eggs. In 2019, with House Bill 19-1329, the General Assembly added explicit exemptions for fertilizer and spray adjuvants for use in agricultural commodity production. The General Assembly did not take any legislative action to clarify whether the other three agricultural inputs are exempt from sales and use taxes.

Farm Close-Out Sales Tax Exemption



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Tax Expenditure Evaluation • May 2023 • 2023-TE9

The Farm Close-Out Sales Tax Exemption exempts property previously used in farming or ranching operations from sales tax when the items are purchased at a farm close-out sale. Farm close-outs occur when a farmer or rancher is abandoning their farming or ranching operation and attempting to make full and final disposition of all of their tangible personal property used in the operation.

The expenditure is likely meeting its purpose because it is being used by the state’s farming and ranching industry. However, the application of the exemption to certain items can be inconsistent and the cost savings vary based on local sales and use tax policies.

- Potential beneficiaries are generally aware of and receiving the exemption, though there may be inconsistencies in how the exemption is applied, such as on smaller equipment that could be used for agricultural or non-agricultural purposes.
- Other state-level exemptions cover many of the same items that are covered by the Farm Close-Out Sales Tax Exemption.
- The exemption’s cost savings to the buyer vary based on the county and municipality where the buyer takes possession of the equipment and the local sales tax rate.
- While stakeholders told us they use the exemption, we could neither determine the extent to which it is used during eligible close-out sales nor how often it is applied.

Policy Considerations

We did not identify any new policy considerations in this evaluation.

Tax Type:	Sales	Year Enacted:	1945
Expenditure Type:	Exemption	Repeal/Expiration date:	None
Statutory Citation:	Section 39-26-716(4)(a), C.R.S.	Revenue Impact (2020):	We could not determine

Purpose given in statute or enacting legislation? **No**

Farm Close-Out Sales Tax Exemption

Background

Colorado imposes sales tax on purchases of tangible personal property within the state. **The Farm Close-Out Sales Tax Exemption (Farm Close-Out Exemption) exempts property previously used in farming or ranching operations from sales tax when the items are purchased at a farm close-out sale.**

Farm close-out sales occur when a farmer or rancher is abandoning their farming or ranching operation and attempting to make full and final disposition of all of their tangible personal property used in the operation. The sales are typically conducted by an auctioneer, but can be conducted by a farmer or rancher through a private sale. In order for property to qualify for the exemption, it must have been used in a farming or ranching operation. For example, agricultural equipment such as tractors, irrigation equipment, and baling materials are exempt. In addition, other non-agricultural property including, but not limited to, motor vehicles, general tools, and mowers could also be exempt as long as the property was used in a farming or ranching operation. Additionally, a farm or ranch owner must sign a written declaration that the property qualifies for the exemption and provide a copy to the buyer, and in cases when items are sold at auction, can provide it to the auctioneer. The exemption is generally applied by the seller at the time of the sale, or in the case of motor vehicles, when the county clerk registers the vehicle.

Technical Note:

Statute defines “motor vehicle” as any self-propelled vehicle that is designed primarily for travel on the public highways and that is generally and commonly used to transport persons and property over the public highways. This does not include a farm tractor or off-highway vehicle.

Typically, sellers do not collect sales tax on the transaction and report the exemption to the Department of Revenue (Department) on Form DR 0100 after the purchase. Alternatively, if a purchaser pays sales tax at the time of the sale, they may request a refund from the Department. If a purchaser takes possession of the property in another state, Colorado sales tax does not apply, and therefore the exemption is not applicable.

The exemption is likely intended to encourage the purchase of used agricultural equipment and supplies from Colorado farmers and ranchers who are closing their agricultural operation by lowering the after-tax cost of the purchase.

The exemption was enacted in 1945 when the United States was involved in World War II and there was a need for additional agricultural production. Specifically, in Colorado, the number of farmers

decreased by approximately 7.4 percent between 1940 and 1945. During the same period, the U.S. Department of Agriculture (USDA) asked farmers in Colorado to increase their production of agricultural products to help the war effort. Therefore, the expenditure may have been originally enacted to encourage new producers in the industry by reducing the cost of equipment. The exemption has remained largely unchanged since.

Statute does not explicitly state the exemption's intended beneficiaries. We inferred that the intended direct beneficiaries are new and continuing farmers and ranchers. According to USDA data, there were approximately 39,000 farms in the state as of 2021 that could potentially benefit from the exemption. Agricultural producers who are closing down their operations likely also benefit, as the exemption lowers the total out-of-pocket cost to buyers, and may encourage higher auction bids of the outgoing producers' equipment.

We developed the following performance measures to evaluate the exemption:

- The extent to which stakeholders are aware of and correctly apply the exemption.
- The extent to which the exemption reduces the cost of farm and ranch equipment for buyers.

Evaluation Results

The expenditure is likely meeting its purpose because it is being used by the state's farming and ranching industry. However, the exemption's application to certain items can be inconsistent and the cost savings can vary based on local sales and use tax policies.

Potential beneficiaries are generally aware of and receiving the exemption. As part of our last evaluation, conducted in 2018, we interviewed five auctioneer groups that conduct farm close-outs in Colorado and all were aware of the exemption. For this evaluation, we contacted two auctioneer groups and they confirmed that awareness was still high within the auctioneer industry. Auctioneers who specialize in agricultural equipment auctions reported that the exemption is important to the agricultural industry in the state. Stakeholders indicated that Colorado farmers often face financial constraints and operate on small profit margins, so the tax savings offered by the exemption provide a meaningful benefit. Farmers closing their operations are also aware that participating in a farm auction close-out sale can drive up the bids on their equipment, because purchasers know they will not have to pay sales tax and may be willing to bid a higher amount.

While stakeholders told us they use the exemption, we could neither determine the extent to which it is used during eligible close-out sales nor how often it is applied. The amount that Farm Close-Out Exemption sellers report to the Department is aggregated with several other agricultural sales tax exemptions (e.g., sales of livestock, feed, bedding, seeds, agriculture compounds, and pesticides [Section 39-26-716(4)(a-c) and 39-26-102(19)(c-g), C.R.S.]). Sellers are

not required to report how much of their exempt sales are due to the Farm Close-Out Exemption; therefore, we were unable to determine how many sellers have applied the exemption or the amount of sales tax that was exempted. As of 2021, the Department reported that these agricultural sales tax exemptions totaled \$20.9 million from about 6,200 filings. Overall, the exemption's revenue impact is likely a small portion of the \$20.9 million total, with two farm close-out auctioneers reporting that farm close-out sales generally occur infrequently. We were able to identify the revenue impact from the application of the exemption to motor vehicle sales for Tax Years 2019 through 2022 because these sales are reported to county motor vehicle offices; however, the impact of these sales is limited to only 55 motor vehicle purchases since 2019—with an annual average cost of \$4,650 to the State.

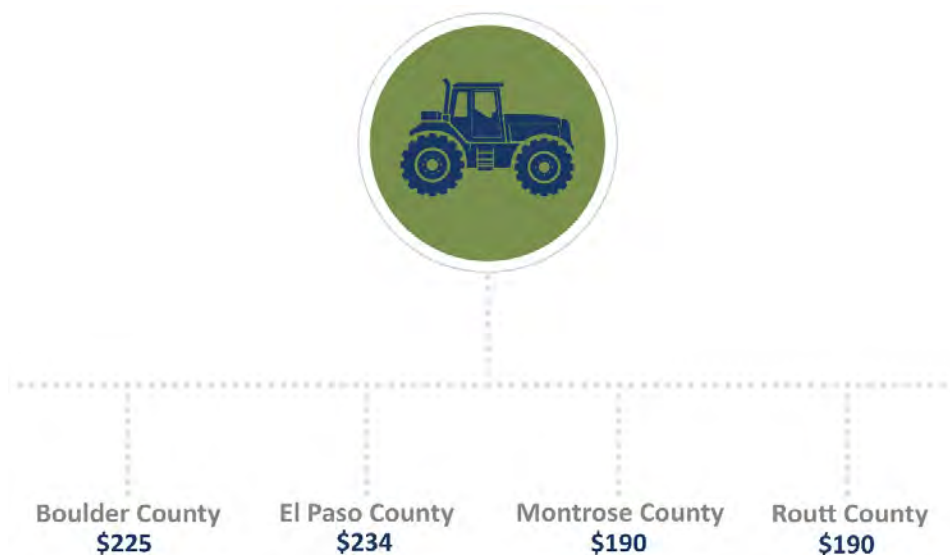
Sellers may apply the exemption inconsistently. The auctioneers we spoke with reported sometimes being uncertain about what items should be included in the exemption, especially for smaller equipment and tools that could be used for agricultural or non-agricultural purposes. For example, it is not always clear whether items in tool shops, spare tires used on tractors or farm vehicles, and tractors or vehicles that have been scrapped and are no longer used in agricultural production should be included in the exemption. Some stakeholders reported that, based on the judgement of the auctioneer or farmer, there may be inconsistencies in the items that are exempted.

Other state-level exemptions cover many of the same items that are sold at farm close-out sales. Colorado has several other agricultural sales and use tax exemptions that were enacted after the Farm Close-Out Exemption, which means agricultural product sales like those mentioned previously, as well as farm equipment used for normal business operations, are already exempt from state sales tax. Based on conversations with stakeholders, most of what is sold at farm close-out sales is equipment that is also exempt from state sales tax due to the broader Farm and Dairy Equipment Sales Exemption [Section 39-26-716(4)(e), C.R.S.]. Because farm equipment is generally already exempt from sales tax during normal sales, the Farm Close-Out Exemption provides a relatively limited benefit at the state level. For example, sales of agricultural equipment, such as tractors, plows, and combines, are exempt from state sales tax under both exemptions. Although the Farm Close-Out Exemption may provide an unduplicated exemption for sales of some items that purchasers do not intend to use as part of an agricultural operation or that are not otherwise exempt, such as general tools, mowers, and on-road motor vehicles, these items likely make up a relatively small portion of property sold at farm close-out sales. We found that only eight other states have a sales tax exemption similar to the Farm Close-Out Exemption, but 32 exempt agricultural equipment used in farming and ranching operations. A likely reason that farm close-out sales exemptions are relatively uncommon in other states is that broader exemptions related to agricultural equipment cover many of the same items in those states, similar to Colorado's Farm and Dairy Equipment Sales Tax Exemption.

The amount purchasers save varies based on local sales tax policies. Statute requires cities and counties that have their sales tax collected by the State to provide the Farm Close-Out Exemption, but they are not required to provide the Farm and Dairy Equipment Sales Tax Exemption—and must opt into it by enacting a local ordinance. Additionally, home rule jurisdictions that collect their

farmers and ranchers to participate in farm close-out sales, especially if they plan to purchase more expensive equipment. For example, as shown in Exhibit 2, a farmer purchasing a \$19,000 used tractor at a farm close-out sale in any of the four counties with the largest number of farms, and only the Farm Close-Out Exemption, would save \$210, based on the average local tax rate for these four counties. This would be in addition to the \$551 in state sales taxes saved due to the Farm Close-Out Exemption or the Farm and Dairy Equipment Exemption, which would both exempt the purchase from the 2.90 percent state sales tax.

Exhibit 2
County Sales Tax Savings on a \$19,000 Tractor in the Four Counties with the Most Farms and Only the Farm Close-Out Exemption



Source: Office of the State Auditor analysis based on local sales tax rates from the Department of Revenue.

Similarly, the Farm Close-Out Exemption provides an unduplicated exemption in 145 of the 160 municipalities with their sales taxes collected by the State because these jurisdictions have not adopted the Farm and Dairy Equipment Exemption. These municipalities have sales tax rates from 1 percent up to 5 percent and the exemption provides a corresponding local tax savings. Additionally, 21 of the State’s 68 home rule jurisdictions with a sales tax, provide a similar unduplicated exemption for farm close-out sales, although these exemptions are established and administered independently from the State’s exemption. The sales tax rates in these jurisdictions range from 3 percent up to 7 percent. As a result, the Farm Close-Out Exemption’s cost savings also vary based on the city or town where the buyer takes possession of the equipment and the local sales tax rate. However, data on the location of the sales or where the buyer takes possession of the items are not available; therefore, we could not determine how often sales occur in a county or municipality with a sales tax exemption.

As a hypothetical example of how tax rates and local exemptions can impact cost savings, Exhibit 3 shows the cost savings on the sale of a \$19,000 tractor in two jurisdictions in Boulder County. Nederland, which has a sales tax rate of 4.25 percent, is required to exempt farm close-out sales versus the City of Boulder, which has a sales tax rate of 3.86 percent, is a home rule city and does not exempt these sales.

Exhibit 3

The Farm Close-Out sales tax exemption provides a larger cost-savings to purchasers in local jurisdictions that are required to provide the exemption.

	Town of Nederland (Local Exemption)	City of Boulder (No Local Exemption)
State Sales Tax Rate	2.9%	2.9%
City Sales Tax Rate	4.25%	3.86%
Total Rate Exempted ¹	7.15%	2.9%
Cost Savings	\$1,358.50	\$551.00

Source: Office of the State Auditor analysis of the cost savings based on the state and municipality sales tax rate that is exempted.

¹ The Town of Nederland and City of Boulder are both located in Boulder County which is required to exempt Farm Close-Out sales from the county tax rate of 1.185%, therefore we did not include the county exemption in the comparison.

Policy Considerations

We did not identify any policy considerations for the Farm Close-Out Exemption. In the previous evaluation of this expenditure in 2018, we included a policy consideration that the General Assembly may want to review, and if necessary, amend the language of the exemption to reflect its tax policy preferences concerning the inclusion of motor vehicles in the exemption. In 2022, House Bill 22-1023 would have excluded motor vehicles that are subject to registration requirements from the Farm Close-Out Exemption. The House Finance Committee voted to postpone the bill indefinitely and therefore, the General Assembly did not take any legislative action on this policy consideration. Due to the low revenue impact of exempting motor vehicles from sales tax in the event of a farm close-out sale (less than \$9,000 in 2022), which is information that was not available at the time of the prior evaluation, we are not repeating that policy consideration in this evaluation.



Long-Term Lodging Exemption



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C O L O R A D O

Tax Expenditure Evaluation • February 2023 • 2023-TE3

Colorado sales tax is generally imposed on amounts charged for rooms or accommodations in hotels and other lodging establishments. The Long-term Lodging Exemption allows people who live in a lodging establishment for at least 30 consecutive days to be exempted from paying state sales tax on the cost of their lodgings. The exemption was likely intended to provide equal tax treatment between people who enter into residential leases, which are not subject to sales tax, and those who reside in lodging establishments on a long-term basis.

We found that the exemption equalizes tax treatment between people who reside in traditional housing and those who live in lodging establishments on a long-term basis when it is applied correctly. However, it appears that some establishments may not be aware of or applying the exemption.

- When the exemption is applied, people living in long-term lodging establishments receive 2.9 percent in tax savings (an estimated \$44 to \$98 per month, or \$529 to \$1,176 per year) on the cost of their housing.
- The exemption may not be applied consistently to all eligible stays. Most accommodation booking websites that we examined do not apply the exemption at the time of booking. However, the majority of respondents of a small sample of lodging establishments appear to be applying the exemption correctly.

Policy Considerations

We did not identify any policy considerations for this exemption.

Tax Type:	Sales tax	Year Enacted:	1959
Expenditure Type:	Exemption	Repeal/Expiration date:	None
Statutory Citation:	Section 39-26-704(3)(a), C.R.S.	Revenue Impact (2021):	\$9.1 million

Purpose given in statute or enacting legislation? **No**

Long-Term Lodging Sales Tax Exemption

Background

Colorado sales tax is generally imposed on amounts charged for rooms or accommodations in hotels and other lodging establishments. **The Long-term Lodging Sales Tax Exemption allows people who live in a lodging establishment for at least 30 consecutive days to be exempted from paying state sales tax on the cost of their lodgings.**

People of all income levels who stay in lodging establishments on a long-term basis can claim the exemption, and we could not identify a source of data to provide demographic information for those who use it. However, some news articles indicate that some low income individuals and families in Colorado may live in hotels or motels because they do not meet the qualifications for renting a residence under a standard lease agreement. Other people who live in temporary accommodations for at least 30 days may include individuals on temporary assignment or working on specific projects, such as traveling nurses, construction workers, and consultants.

In order to qualify for the exemption, the permanent resident must have a written agreement for occupancy of the accommodations for at least 30 consecutive days, which, under Department of Revenue (Department) regulations, can include a hotel registration or rent receipt. The exemption is generally applied by the lodging establishment at the time of sale. Alternatively, if the resident is incorrectly charged for sales tax at the time of sale, they may submit a request for a refund to the Department.

Of the 47 other states and the District of Columbia that apply state sales tax and/or lodging tax to the cost of accommodations, we determined that 44 states exempt long-term stays from one or both of these taxes. The minimum length of stay to qualify for the exemption varies, but the most common is 30 days.

The exemption was likely intended to provide equal tax treatment between people who enter into residential leases, which are not subject to sales tax, and those who reside in lodging establishments on a long-term basis.

The exemption was enacted in 1959 with the same legislation that imposed the state sales tax on amounts paid for lodgings, which suggests that the legislature only intended to impose sales tax on short-term stays in lodgings. The exemption has remained largely unchanged since then, with the

exception of House Bill 20-1020, which the General Assembly passed in 2020 to limit the exemption to “any natural person,” which are individuals rather than businesses. Based on the bill’s legislative declaration, this change was intended to restrict the exemption’s availability in accordance with the exemption’s “presumed original purpose of providing equal tax treatment for persons who enter into residential leases of 30 days or more and persons who stay for more than 30 days in lodgings that are typically used for short-term stays.”

In addition to limiting the exemption to natural persons, House Bill 20-1020 also requires local governments with a state-collected local sales tax to apply the exemption to local sales taxes unless local ordinances expressly tax long-term lodgings. Statute does not limit the local exemption to natural persons but rather allows any “occupant” of the accommodations to claim the exemption.

Performance Measures. In order to determine whether the exemption is meeting its purpose, we assessed the extent to which the exemption equalizes tax treatment between traditional housing and lodging establishments, and whether establishments are aware of and correctly applying the exemption.

Evaluation Results

We found that the exemption equalizes tax treatment between people who reside in traditional housing and those who live in lodging establishments on a long-term basis when it is applied correctly. However, it appears that some establishments may not be aware of or applying the exemption correctly.

When the exemption is applied correctly, its beneficiaries receive 2.9 percent in tax savings (an estimated \$44 to \$98 per month, or \$529 to \$1,176 per year) on the cost of their housing. Exhibit 1 estimates the monetary benefit that people living in accommodations establishments may receive as a result of the exemption. As shown, the exemption could provide about \$44 in savings per month at a lower-cost hotel. Representatives of an association that provides services to the homeless population stated that these savings could be significant for low income families; for example, \$44 could help a family pay for food for a week.

Exhibit 1

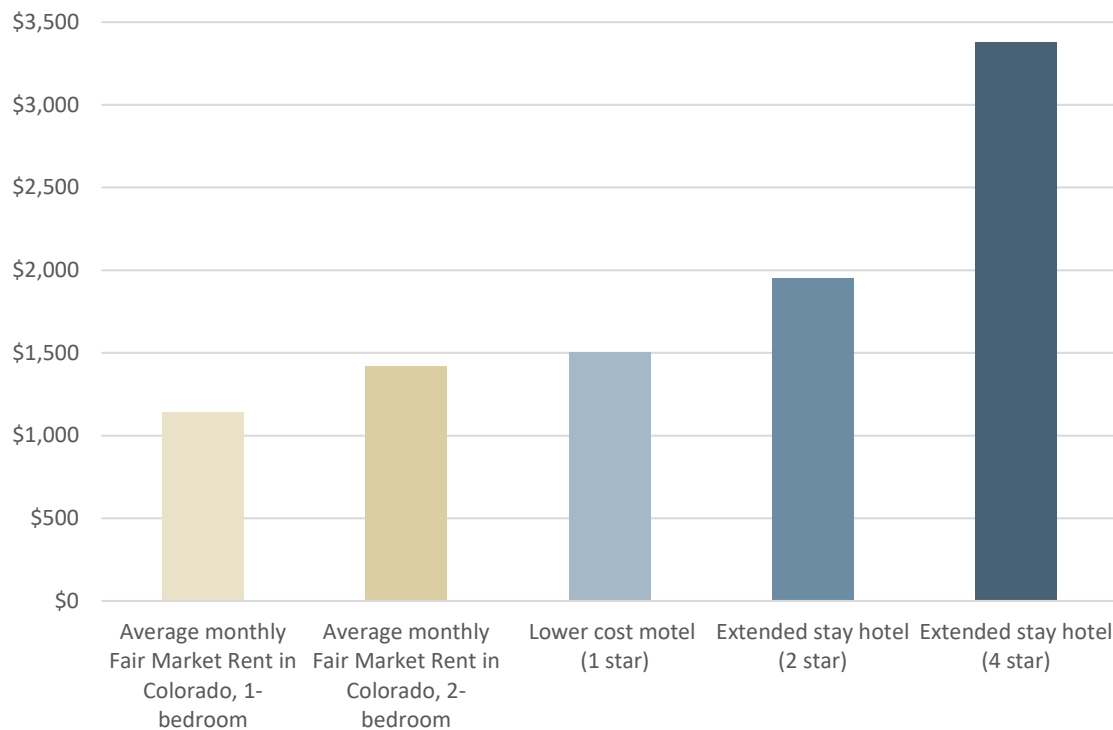
Estimated Exemption Benefit to Residents of Accommodations Establishments

Type of Accommodations	Estimated Monthly Cost of Accommodations Without Exemption	Colorado Sales Tax Rate	Estimated Monetary Benefit, Monthly	Estimated Monetary Benefit, Annual
Lower cost motel (1 star)	\$1,544	2.90%	\$44	\$529
Extended stay hotel (2 star)	\$2,007		\$57	\$688
Extended stay hotel (4 star)	\$3,478		\$98	\$1,176

Source: Office of the State Auditor analysis of typical accommodations costs and the Colorado sales tax rate.

While the exemption does equalize the tax treatment between long-term accommodations and traditional housing, even with the exemption, long-term stays in lodging establishments are generally much more expensive than comparable housing obtained through a traditional rental lease, with the exemption providing a relatively small reduction in the additional cost of long-term stays. Although we were unable to determine the average cost of living permanently in temporary accommodations in Colorado, Exhibit 2 provides some examples of possible housing costs incurred by people who live in temporary accommodations compared with typical housing costs for those who live in traditional housing.

**Exhibit 2
Comparison of Monthly Fair Market Rent¹ in Colorado (2021) with Estimated Cost of 30-day Stay in Colorado Lodging Establishments**



Source: Office of the State Auditor analysis of Colorado lodging establishment prices as of January 2023 and US Department of Housing and Urban Development Fair Market Rents 2021 data.

¹FMRs are estimates of the 40th percentile gross rents for “standard quality units” in a given location and are used to determine the benefits provided under various HUD income-based housing programs.

Some booking websites and lodging establishments might not apply the exemption to all eligible stays. We examined 12 accommodation booking websites that allow long-term stays and found that 10 do not apply the long-term lodging exemption at the time a reservation is created, even if the cost of the stay is nonrefundable. It is possible that some of these lodging establishments would apply the exemption upon final payment; for example, some of the websites notify customers that the actual sales tax rates applied may change after the reservation is booked. However, we

lacked information necessary to determine how often this may occur. Additionally, when we spoke with lodging establishments directly, the majority of respondents — seven out of nine establishments that allow guests to stay for 30 days or more— were aware of the exemption and appear to be applying it correctly, one respondent was unaware of the exemption, and the final respondent indicated that they might not automatically apply the exemption. As noted above, eligible customers who do not receive the exemption can apply for a refund through the Department, but due to how the information is stored in the State’s tax system, GenTax, we were unable to determine how often they do so.

None of the lodging establishments we spoke to were aware of the changes to the exemption that occurred as a result of House Bill 20-1020, i.e. limiting the exemption to natural persons. However, several establishments reported that they either do not allow businesses to pay for long-term stays on behalf of the businesses’ staff or have not come across this situation, so the restriction of the exemption to natural persons is not generally applicable to their operations. Additionally, an industry representative stated that hotels that contract with businesses for long-term use of rooms (e.g. for airlines booking a set of rooms for flight crews) do not allow the exemption on these contracts.

We estimated that the exemption had a revenue impact of about \$9.1 million to the State in Tax Year 2021.

Lodging establishments report exempt sales of long-term stays along with other exempt sales on the same reporting line of the Colorado sales tax return, so we were unable to obtain data necessary to provide an exact estimate of the exemption’s revenue impact. However, Department data indicates that the accommodations industry reported about \$312 million in tax-exempt sales in Tax Year 2021. Since most of the other exemptions included in this data are unlikely to be applied frequently to accommodations industry sales, the long-term lodging exemption likely accounted for most of the \$312 million in exempt sales, for a total state revenue impact of about \$9.1 million.

Policy Considerations

We did not identify any policy considerations for this exemption.



Newsprint & Printer’s Ink and Newspapers Exemptions



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Tax Expenditure Evaluation • May 2023 • 2023-TE6

The Newsprint & Printer’s Ink Exemption allows newspaper publishers and commercial printers to purchase newsprint and printer’s ink without paying state sales and use tax. The exemption was likely created to define the types of sales subject to state sales tax and avoid charging sales taxes on the production inputs of newspapers and commercial printers.

The Newspapers Exemption exempts the purchase and distribution of newspapers from state sales and use tax and was likely created to clarify which purchases were intended to be taxed under the State’s sales tax, which was enacted in 1935.

The exemptions are meeting their purposes because newspaper publishers, commercial printers, and newspaper retailers are aware of the exemptions and both exemptions appear to be applied to eligible sales.

- Representatives from Colorado newspapers reported that they have not paid state sales or use tax on newsprint and printer’s ink.
- Representatives from newspapers that we spoke with reported that their newspapers are consistently exempted from state sales and use tax.

Policy Considerations

We did not identify any policy considerations in this evaluation.

	Newsprint & Printer’s Ink	Newspapers
Tax Type:	Sales and Use	Sales and Use
Expenditure Type:	Exemption	Exemption
Statutory Citation:	Sections 39-26-102(21)(a) and 705(1), C.R.S.	Section 39-26-102(15)(a)(I), C.R.S.
Year Enacted:	1943 (sales tax), 1945 (use tax)	1943
Repeal/Expiration Date:	None	None
Revenue Impact:	\$300,000 (2021)	\$2.7 million (2017)
Purpose given in statute or enacting legislation? No		

Newsprint & Printer's Ink and Newspapers Exemptions

Background

This evaluation covers two related tax expenditures:

- **The Newsprint & Printer's Ink Exemption allows newspaper publishers and commercial printers to purchase newsprint and printer's ink without paying state sales and use tax.**
- **The Newspapers Exemption exempts the purchase and distribution of newspapers from state sales and use tax.**

We inferred that newspaper publishers and commercial printers are the intended beneficiaries of the Newsprint & Printer's Ink Exemption since they are the only eligible parties. Newspaper purchasers might also indirectly benefit from the Newsprint & Printer's Ink Exemption because some of the savings on paper and ink may be passed on to purchasers through lower retail prices. We inferred that the intended beneficiaries of the Newspapers Exemption are newspaper purchasers and newspaper publishers, including publishers of free newspapers since they would be responsible for paying use tax if the exemption did not exist. Both exemptions were created in 1943, and the use tax exemption was added to the Newsprint & Printer's Ink Exemption in 1945.

The Newsprint & Printer's Ink Exemption was likely created to define the types of sales subject to state sales tax and avoid charging sales taxes on the production inputs of newspapers and commercial printers. This exemption is consistent with other sales tax exemptions in the state, which exempt purchases of raw materials that are incorporated into a final product. Similar structural provisions are common in states with a sales tax to prevent the tax from being applied at multiple stages of a good's manufacturing and distribution process, which is referred to as "tax pyramiding." Tax pyramiding can increase the effective tax on a consumer good to the extent that taxes on manufacturers' inputs are passed on to the final consumers of their products. Of the 44 other states that impose a retail sales or similar tax, 43 provide an exemption for newsprint and printer's ink, either by exempting them specifically or because they are considered to be component parts of a manufactured product, which are also typically exempt from sales tax.

The Newspapers Exemption was likely created to clarify which purchases were intended to be taxed under the State's sales tax that was enacted in 1935. Specifically, the legislative

declaration for House Bill 43-155, which created the exemption, states that it was always the General Assembly’s intent to exempt newspapers in their entirety from sales and use tax and that, in practice, they had never been taxed. This policy is consistent with other states with a sales tax, most of which have historically exempted newspapers from sales taxes because of their importance in fostering a more informed public and serving as a forum for posting required legal notices. Thirty-two states exempt newspapers from sales tax.

In order to determine whether the exemptions are meeting their purposes, we assessed the extent to which sales of newsprint and printer’s ink purchased by newspaper publishers and commercial printers, along with newspapers purchased by consumers, are being exempted from state sales and use tax.

Evaluation Results

The exemptions are meeting their purposes because newspaper publishers, commercial printers, and newspaper retailers are aware of them and both exemptions generally appear to be applied to eligible sales.

Although we lacked data to confirm the exemptions are always applied, during our 2018 evaluation of these tax expenditures, we interviewed representatives from 23 Colorado newspapers—two of which oversee substantial printing operations of national and local newspapers in Colorado—and all of them reported that they have not paid state sales or use tax on newsprint and printer’s ink. Both large printers reported that newsprint and printer’s ink have continuously and consistently been exempted from Colorado sales and use tax—although some printers noted that they periodically must provide their printer’s ink suppliers or distributors with documentation, such as an affidavit, attesting that the ink is being used to print newspapers. In 2022, during our most recent evaluation, our outreach to industry representatives confirmed that they have continued not to pay state sales or use tax on newsprint and printer’s ink. The newspaper representatives we contacted in 2018 and 2022 reported that retail sales of their publications are also consistently exempted from state sales and use tax. Additionally, the Department of Revenue has issued guidance and regulations, which provide that newspaper sales should not be subject to state sales tax.

We estimate that the Newsprint & Printer’s Ink Exemption had a revenue impact to the State of about \$300,000 in Calendar Year 2021, which is a \$200,000 decrease from its 2017 revenue impact. Based on the volume of newsprint sold and the average price of newsprint in Colorado in 2021 provided by the Pulp and Paper Products Council, we estimated that approximately \$10.1 million in newsprint and about \$600,000 in printer’s ink sales

Technical Note:

We were unable to identify a source to directly obtain data on total printer’s ink sales in Colorado; however, we used data provided by two large newspaper printers in Colorado to create an average ratio of the cost of printer’s ink compared to newsprint, which, as of 2017, was about \$0.06 for every \$1.00 of newsprint sales. We used the ratio to estimate that there were about \$600,000 in eligible printer’s ink sales in Colorado in 2021.

occurred in Colorado in 2021. We then multiplied the printer's ink and newsprint sales estimates (totaling \$10.7 million) by the State sales tax rate of 2.9 percent, which resulted in an estimated \$300,000 revenue impact to the State. Using the same methodology in our 2018 evaluation, we estimated the revenue impact was \$500,000 in 2017, so the exemption's revenue impact has decreased in recent years due to lower sales of newsprint and printer's ink.

Due to trends in the newspaper industry, the revenue impact of this expenditure will likely decline over time. While the price of newsprint has gradually risen over the last 10 years, the demand in Colorado for newsprint has continually and substantially declined since print circulation has decreased for most newspapers. This exemption will likely have a diminishing impact on state tax revenue as demand for newsprint and printer's ink continues to decline.

In our 2018 evaluation, we estimated that the Newspapers Exemption reduced state tax revenue in Calendar Year 2017 by about \$2.7 million. It is likely that the revenue impact of the Newspapers Exemption has decreased since 2018, but we were unable to estimate a more recent revenue impact because the U.S. Census Bureau no longer publishes data on newspaper subscription sales by state, which is the data we used to estimate the revenue impact for Calendar Year 2017. According to the Pew Research Center, nationally, total circulation revenue for local newspapers dropped from \$1.5 billion in 2019 to \$1.1 billion in 2020. Additionally, demand for newsprint in the state also decreased substantially (41 percent) between 2018 and 2021, so it is likely that sales from print newspapers have decreased as well. This is consistent with stakeholder feedback from newspapers that print subscription sales have decreased, although newspapers mentioned that they have increased print subscription prices, which may partially offset some of the expected decrease in the revenue impact of the Newspapers Exemption.

In addition to the state exemption, sales of newsprint and printer's ink to newspaper publishers and commercial printers and sales of newspapers are exempt from local sales taxes levied by local governments that have their sales taxes collected by the State on their behalf. Statute mandates that these local governments apply most of the State's sales tax exemptions, including the Newsprint & Printer's Ink Exemption and Newspapers Exemption. Home rule municipalities established under Article XX, Section 6 of the Colorado Constitution that collect their own taxes have the authority to set their own tax policies independent from the State and are not required to exempt such sales from their local sales tax. Based on our review of the 15 most-populated home rule cities, all exempt both newsprint and printer's ink from sales tax, and only Denver and Broomfield impose a sales tax on newspapers. We estimated that the exemption reduced local government revenue by \$1.7 million in Calendar Year 2017. To estimate this amount, we used the same newspaper sales estimate (\$91.4 million) arrived at for calculating the state revenue impact, but applied the average population-weighted local sales tax rate of 1.8 percent after excluding home rule jurisdictions with self-collected sales taxes. Because we were unable to estimate a more current State-level revenue impact for the Newspapers Exemption for this report, we also were not able to estimate a more current local government revenue impact.

Policy Considerations

We did not identify any policy considerations for these exemptions. In our previous evaluation of the Newsprint & Printer's Ink and Newspapers Exemptions, released in September 2018, we included a policy consideration that the General Assembly could consider clarifying whether digital newspapers or other electronic news sources are also exempt from sales and use tax. The General Assembly did not take any legislative action on this policy consideration.



Sales to Charitable Organizations Exemption



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C O L O R A D O

Tax Expenditure Evaluation • May 2023 • 2023-TE8

The **Sales to Charitable Organizations Exemption** exempts purchases made by charitable organizations from sales tax. The exemption was likely intended to avoid imposing a tax burden on charitable organizations, since these organizations may benefit the public and reduce the need for government services.

We found that charitable organizations are aware of and able to use the exemption.

- Most stakeholders indicated that charitable organizations are aware of this exemption and commonly use it, and some also noted that this exemption has a major impact on Colorado's non-profit sector and allows charitable organizations to provide more assistance to those they serve.
- Although veterans organizations are exempt from state sales tax, depending on where a sale occurs, they might not qualify for a local sales tax exemption and, therefore, may have to pay local sales taxes.
- We could not determine the exemption's impact on state revenue because vendors report exempt sales to charitable organizations on the same line of their Colorado sales tax returns as sales to a number of other exempt entities, including schools, housing authorities, the State of Colorado, and local governments.

Policy Consideration

We did not identify any new policy considerations for the exemption.

Tax Type:	Sales & Use Tax	Year Enacted:	1935
Expenditure Type:	Exemption	Repeal/Expiration date:	None
Statutory Citation:	Section 39-26-718(1)(a), C.R.S.	Revenue Impact:	Could not determine

Purpose given in statute or enacting legislation? **No**

Sales to Charitable Organizations Exemption

Background

The Sales to Charitable Organizations Exemption exempts purchases made by charitable organizations from sales tax.

Charitable organizations that are registered with the Secretary of State and that qualify as exempt from federal income tax under Internal Revenue Code 501(c)(3) for charitable organizations, or Internal Revenue Code 501(c)(19) for veterans services organizations, can qualify for the exemption. In order to claim the exemption, eligible organizations must apply for a certificate of exemption from the Department of Revenue (Department). Organizations then present the certificate to retailers at the point-of-sale, and retailers apply the exemption by not collecting the State's 2.9 percent sales tax on eligible sales. According to the Department, retailers are expected to verify the validity of the certificate of exemption and report the total exempt sales when they remit the sales taxes they collected to the State. If the exemption is not applied at the time of sale, the charitable organization can also apply for a refund by submitting the appropriate forms to the Department within 3 years.

The exemption was likely intended to avoid imposing a tax burden on charitable organizations, since these organizations may benefit the public and reduce the need for government services. The exemption was established in 1935 at the same time as the Colorado sales tax, indicating that the General Assembly's intention was to exempt charitable organizations from sales tax when it was created. The only substantial change to the exemption occurred in 2018 when the General Assembly amended it to include nonprofit veterans organizations with 501(c)(19) tax status.

Technical Note

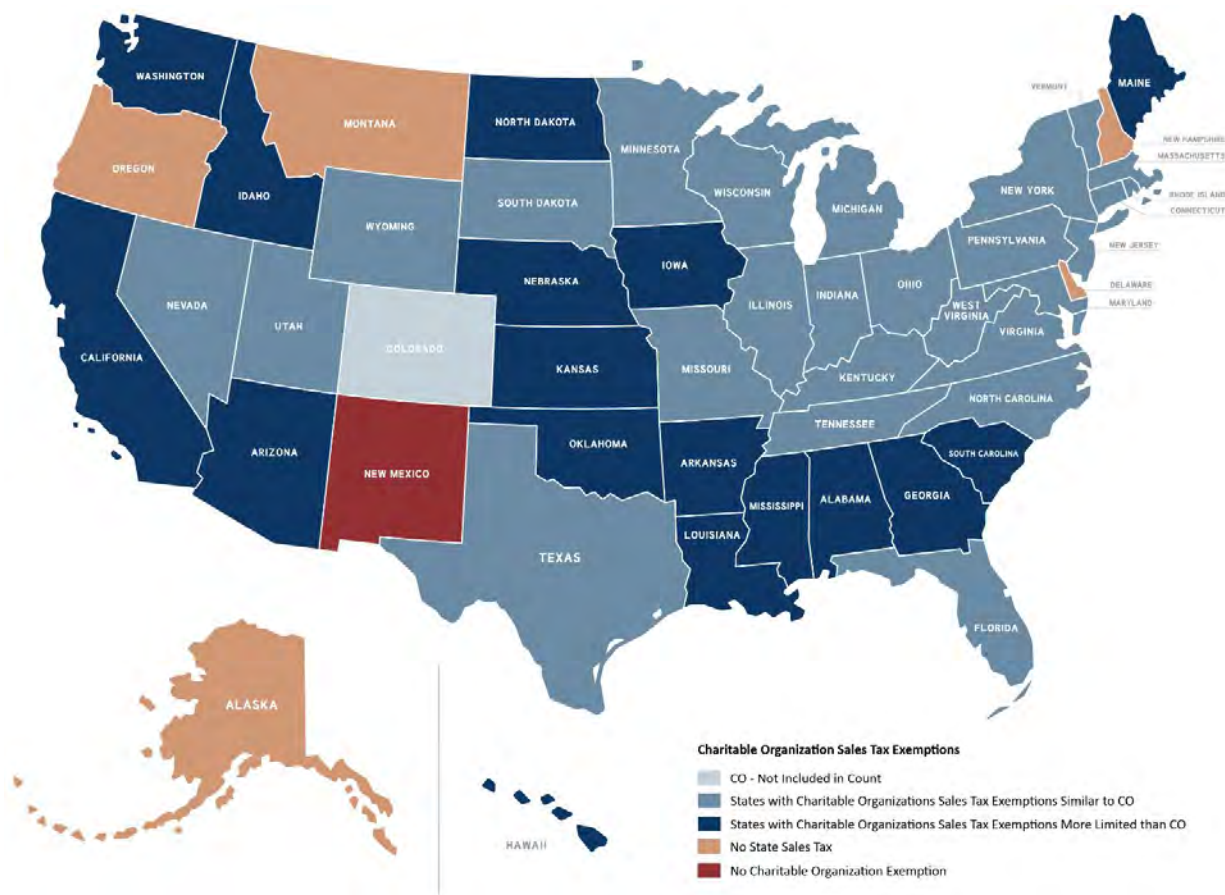
According to statute, a charitable organization may qualify if they meet the following criteria:

- a. Must be organized and operated exclusively for certain purposes given in statute, such as religious, charitable, scientific, testing for public safety, literary, or educational purposes; fostering national or international amateur sports competition; or the prevention of cruelty to children or animals; or be a veterans organization recognized under 501(c)(19).
- b. None of the organization's net earnings may inure to any private shareholder or individual.
- c. May not participate in, or intervene in, any political campaign on behalf of any candidate for public office, carry on propaganda, or be organized primarily to influence legislation.

The exemption is consistent with the general tax policy of the State and federal governments to avoid taxing charitable organizations. Specifically, in addition to being exempt from sales tax, charitable organizations are also exempt from Colorado and federal income taxes and Colorado property taxes on real and personal property.

Similar to Colorado, most other states exempt charitable organizations from paying sales tax. As provided in Exhibit 1, 26 of the 44 other states (excluding Colorado) that impose a state sales tax and the District of Columbia have broad exemptions similar to Colorado’s, and 17 of the 44 other states offer some form of exemption that is not as broad as Colorado’s. For example, Oklahoma offers an exemption to enumerated organizations, such as the Boy and Girl Scouts of U.S.A., while Louisiana exempts food banks but no other types of organizations. Only New Mexico, which has a gross receipts tax which is paid by vendors, offers no form of sales tax exemption to charitable organizations.

Exhibit 1
Charitable Organization Sales Tax Exemptions by State



Source: Office of the State Auditor analysis of data from Bloomberg Law 2022.

The direct beneficiaries of the exemption are the charitable organizations that save money by not paying sales tax. Additionally, individuals who receive expanded services from the exempt organizations due to the tax savings also likely benefit from the exemption. Studies have found that government support of charitable organizations has a beneficial impact to society. For example, research published in 2009 from the Congressional Research Service, a Federal agency, found that government subsidization of charitable activities can increase society's overall well-being by improving access to community resources such as education and improved infrastructure. Further, an article published in 2021 in the Journal of Public Administration Research and Theory found that a robust nonprofit industry supports higher levels of social capital, self-reported health, infant health, and good mental health in communities. In addition, a study published in 2017 supported by non-profits, local governments, and academic organizations to show the non-profit sector's impact in Colorado estimated that the non-profit industry accounts for 5.1 percent of employment (nearly 190,000 jobs) in Colorado. This industry accounts for approximately a quarter of the state's educational services sector and a third of the health care and social assistance sector.

Evaluation Results

We found that charitable organizations are aware of and able to use the exemption.

Stakeholders have generally reported that they are aware of the exemption and claim it on eligible purchases. We conducted a survey of charitable organizations during our 2018 evaluation of the exemption, and 124 of the 152 survey respondents (82 percent) indicated that they used the exemption for most of their purchases. We conducted more limited outreach during the current evaluation because the only significant change to the exemption since our previous survey was the expansion of the exemption's eligibility to include veterans organizations. Of the 37 stakeholders that we contacted in 2023, we received responses from an industry association representing non-profit organizations in Colorado, one Veterans Service Officer, and one director of a veterans organization registered under Internal Revenue Code 501(c)(19). During both evaluations, most stakeholders indicated that charitable organizations are aware of this exemption and commonly use it, and some also noted that this exemption has a major impact on Colorado's nonprofit sector and allows charitable organizations to provide more assistance to those they serve. We did note that about one-third of respondents to our 2018 survey reported some difficulty accessing the exemption at point of sale, but we were unable to determine how frequently these issues may occur.

Although veterans organizations are exempt from state sales tax, depending on where a sale occurs, they might not qualify for a local sales tax exemption and, therefore, may have to pay local sales taxes. Statute requires local governments that have their local sales taxes collected by the State on their behalf to apply most of the State's sales tax exemptions, including the Sales to Charitable Organizations Exemption. Therefore, both charitable organizations and veterans organizations would receive an exemption from local sales tax in these jurisdictions. However, home rule municipalities that collect their own taxes have the authority to set their own tax policies

independent from the State and are not required to exempt sales to charitable organizations from their local sales taxes. Colorado's top 12 most populous cities are home-rule jurisdictions that collect their own taxes. All 12 offer exemptions from sales tax for charitable organizations, but not all offer an exemption for veterans organizations. Specifically, seven of these cities have a process similar to the State, requiring an application for a certificate of exemption, but only recognize charitable organizations that have been granted tax-exempt status from the federal government under Internal Revenue Code 501(c)(3). The City of Denver no longer requires a letter of exemption for their charitable exemption but does require the organization to have 501(c)(3) status. Thus, veterans organizations, which are granted tax-exempt status under Internal Revenue Code 501(c)(19), would not be eligible for an exemption certificate in these cities and would be required to pay local sales taxes, which range from 2 to 7 percent. The remaining 4 of the 12 honor the state-issued exemption certificate, so veterans organizations would receive a local sales tax exemption in addition to the state exemption in these jurisdictions.

We could not determine the exemption's impact on state revenue because vendors report exempt sales to charitable organizations on the same line of their Colorado sales tax returns as sales to a number of other exempt entities, including schools, housing authorities, the State of Colorado, and local governments. As such, it is not possible to use Department data to determine how much sales tax revenue was forgone as a result of exempt sales to charitable organizations as opposed to sales to these other qualifying entities. According to Department data, in 2021, the State forwent about \$479 million in sales tax revenue due to sales to all of these qualifying entities. In our previous evaluation, we used information from our stakeholder survey and IRS data on charitable organizations to estimate that the exemption for sales to charitable organizations alone resulted in about \$45 million in forgone revenue to the State in 2016. However, since we did not conduct a new survey for the current evaluation, we did not repeat this methodology to develop a new revenue impact estimate for 2021.

Policy Consideration

We did not identify any new policy considerations for the exemption. In our previous evaluation of the exemption, released in September 2018, we included a policy consideration informing the General Assembly that some charitable organizations reported experiencing issues with receiving the exemption due to retailers not applying it consistently. The General Assembly did not take any legislative action on this policy consideration.



Wholesales Sales Tax Exemption



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C O L O R A D O

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The Wholesales Sales Tax Exemption is available to any purchaser with a sales tax license who is making a purchase of goods in Colorado for resale. The exemption was likely intended to ensure that the sales tax is only applied to purchases made by consumers and to promote a transparent tax system. Exempting wholesale sales from sales tax avoids levying the tax on each transaction made between different businesses that handle a product during its distribution chain, which would result in “tax pyramiding”—when a single product is taxed multiple times before it is sold to the consumer. This would compound the tax, making the actual taxes paid higher than the set rate and driving up the price before the item reaches the consumer. In this way, tax pyramiding also reduces the transparency of the tax system by hiding the true amount of sales tax paid by the consumer.

We found that the Wholesales Exemption is effective because it is frequently used by qualifying businesses.

- Taken together, the revenue impact for all types of wholesales exemptions in 2021 was \$3 billion. We could not determine what portion of this amount was specifically attributable to exempted wholesales purchased for resale.
- This exemption was established in 1935 as part of the legislation that created the Colorado retail sales tax, so it is well-established within Colorado’s sales tax system.
- This type of wholesale exemption is common in other states as well, so retailers who operate in other states in addition to Colorado are probably familiar with similar exemptions in those states.

Policy Consideration

We did not identify any policy considerations for the exemption.

Tax Type:	Sales and use tax	Year Enacted:	1935
Expenditure Type:	Exemption	Repeal/Expiration Date:	None
Statutory Citation:	Sections 39-26-102(9), (19)(a), and 39-26-104(1)(a), C.R.S.	Revenue Impact:	Could not determine

Purpose given in statute or enacting legislation? **No**

Wholesales Sales Tax Exemption

Background

The Wholesales Sales Tax Exemption (Wholesales Exemption) is available to any purchaser with a sales tax license who is making a purchase of goods in Colorado for resale.

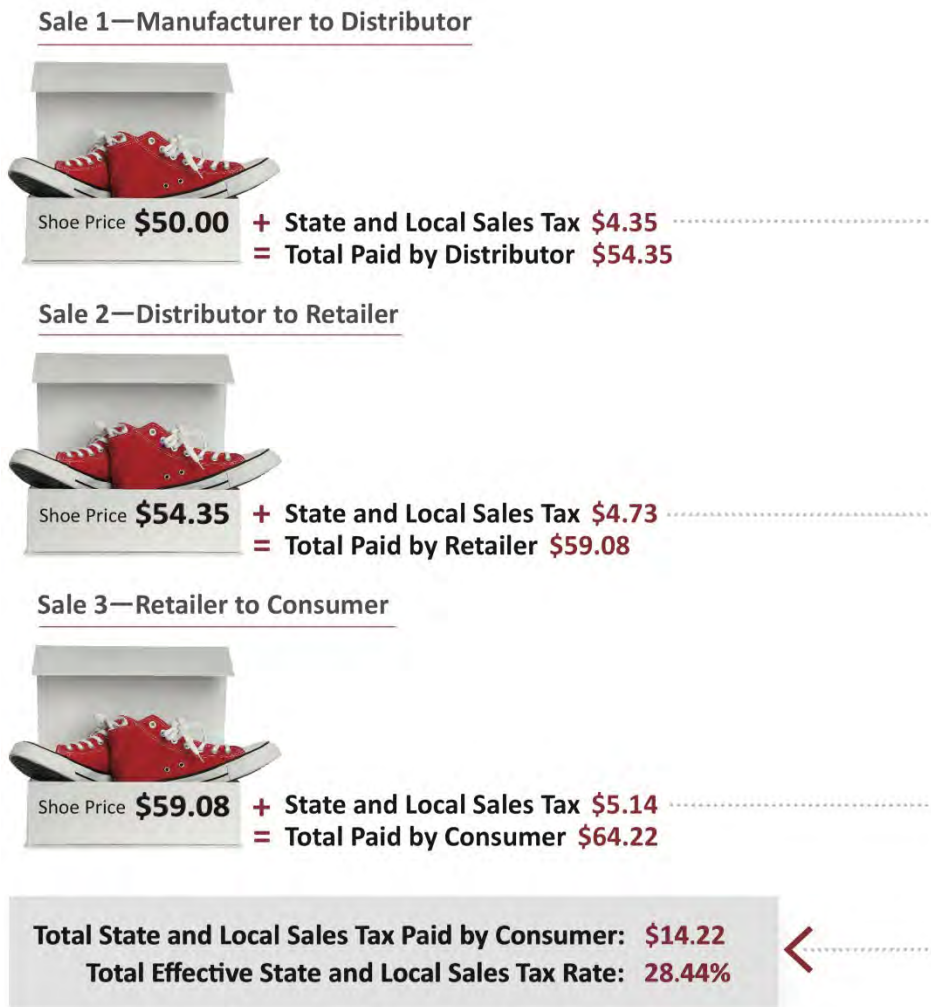
The exemption is applied at the point of sale by vendors who then report all exempted sales to the Department of Revenue (Department). Wholesale purchasers present their sales tax license to the vendor at the point of sale, and the vendor applies the exemption by not collecting the State's 2.9 percent sales tax on the sale. If a vendor has reason to believe that the item purchased is not intended for resale and are unable to verify otherwise, they may apply the sales tax. If the purchaser feels that sales tax has been applied in error, they may file a Claim for Refund form with the Department. We issued our prior evaluation of this exemption in September 2018.

The Wholesales Exemption covers purchases made specifically for resale. Our evaluations of exemptions for other wholesale purchases that are not made for resale but are exempted from sales tax under statute, such as agricultural inputs, ingredients and component parts used in manufacturing, and newsprint and printers' ink, are contained in separate reports.

Although not given in statute, we believe the purpose of the exemption is to ensure that the sales tax is only applied to purchases made by consumers and to promote a transparent tax system. Exempting wholesale sales from sales tax avoids levying the tax on each transaction made between different businesses that handle a product during its distribution chain, which would result in "tax pyramiding"—when a single product is taxed multiple times before it is sold to the consumer. Tax pyramiding can increase the sales tax paid by consumers if businesses in the distribution chain pass on the taxes they pay to subsequent purchasers in the form of higher prices. Exhibit 1 provides an example of how tax pyramiding can occur in the absence of an exemption for resales.

Exhibit 1

Hypothetical Example¹ of the Sale of Shoes without the Wholesales Exemption



Source: Office of the State Auditor analysis of state and local government tax rates.

¹We added Estes Park's total local tax rate of 5%, Larimer County's 0.8% tax rate, and the Colorado state sales tax rate of 2.9% to calculate a combined state and local sales tax rate of 8.7%. We chose a hypothetical shoe price for illustration purposes and did not account for any markup that vendors may add to the amount they pay for the shoes in order to make a profit. Our calculations are based on the assumption that each vendor passes on the entire amount of sales tax they pay to the next purchaser.

As shown in Exhibit 1, tax pyramiding compounds the tax each time a product is sold from one business to the next, making the actual taxes paid higher than the set rate and driving up the price before the item reaches the consumer. In this way, tax pyramiding also reduces the transparency of the tax system by hiding the true amount of sales tax paid by the consumer. For sales of items that have been identified in statute as tax-exempt for the consumer—such as food for home consumption and hygiene products—the sale to the consumer would not be subject to sales tax, but the final price may still be higher due to the cost of sales taxes charged at earlier stages of distribution being passed on to the consumer.

Tax pyramiding can also harm businesses that sell products with longer distribution chains. Since these less integrated businesses must make more sales transactions to purchase and distribute the product before it is sold to a consumer, it may be more difficult for businesses with this structure to compete with businesses with a more integrated distribution system. Using the manufacturer in Exhibit 1 above as an example, if another shoe manufacturer operated its own distribution system and retail stores, its shoe would only be taxed once (when sold at retail), allowing the seller to offer the shoe at a substantially lower price to consumers (e.g., \$54.35 compared to \$64.22). In this situation, a business with a longer distribution chain may choose to absorb all or a portion of the additional tax caused by tax pyramiding to offer a lower price and remain competitive. However, this would reduce profitability and may not be sustainable depending on the profit margin of the product being sold. Since the Wholesales Exemption avoids compounding the tax that must be paid by either the consumer or by businesses that distribute and sell goods, we considered both the businesses that claim the exemption and consumers to be the exemption's intended beneficiaries.

Evaluation Results

We found that the Wholesales Exemption is effective because it is frequently used by qualifying businesses.

According to Department data, in 2021, the State forwent about \$3 billion in sales and use tax revenue due to all types of wholesale exemptions. Although we could not quantify the portion of this amount specifically attributable to the Wholesales Exemption, a substantial portion of the revenue impact is likely attributable to this exemption due to the commonality of sales for resale. Additionally, the exemption is likely well-known by the businesses that qualify for it because it is a common structural provision in nearly every state with a sales tax (44 of 45 other states with a sales tax, including the District of Columbia, have a similar exemption) and has been part of Colorado's sales tax code since 1935, when the State's sales tax was established.

The exemption also applies to some local sales taxes in the state. Statute requires local governments that have their local sales taxes collected by the State on their behalf to apply most of the State's sales tax exemptions, including the Wholesales Exemption. Additionally, home rule municipalities, which have the authority to set their own sales tax policies independent from the State's, also generally exempt wholesales for resale from their local sales tax. The top 12 most populous cities in Colorado are home rule jurisdictions that collect their own taxes, and all 12 exempt wholesales for resale.

We did not receive any feedback from stakeholders to indicate that they had any issues with the exemption. We contacted 30 organizations via email and telephone to discuss their awareness of the exemption and whether they had any issues using it. None of the stakeholders we reached out to followed up or offered their feedback on the exemption.

Policy Consideration

We did not identify any policy considerations for the exemption, nor were there any policy considerations in the previous evaluation.



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